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## The Real Value of Tax Deferral

Christopher H. Hanna

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## THE REAL VALUE OF TAX DEFERRAL

*Christopher H. Hanna\**

### ABSTRACT

A leading law professor wrote a quarter-century ago that deferral of gain “is not as serious as outright exemption, but it is the next best thing.”<sup>1</sup> Few tax law academics would disagree. But how important is tax deferral in the real world, particularly with respect to the Fortune 500 companies and other publicly held corporations, on which I focus and refer to as “Corporate America”? In this Article, I propose that tax exemption and tax deferral are worlds apart. Tax law views tax deferral as a significant benefit for a corporation. Even if tax rates remain constant over time, there is a time value of money benefit in deferring the payment of taxes. But in an accounting analysis, tax deferral appears, on many occasions, to confer only minor benefits. Exclusions (and deductions that are equivalent to exclusions, such as the manufacturing deduction) create the “permanent differences” that are a much greater benefit to Corporate America. Permanent differences can increase a corporation’s net income and therefore its earnings per share—factors that buoy a stock’s price—while at the same time reducing a corporation’s effective tax rate. In contrast, tax deferral items, which produce temporary differences for financial accounting purposes, do not immediately increase a corporation’s net

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\* Altshuler Distinguished Teaching Professor and Professor of Law, Southern Methodist University Dedman School of Law, Dallas, Texas. I would like to thank Mike Donohue, Gray Fontenot, Bernhard Grossfeld, Dan Halperin, Edward Hanna, Mike Kimps, Dan Leightman, Cym Lowell, David Rosenbloom, Todd Wilson and Paul Yong for their comments on an early draft of this Article.

1. William D. Andrews, *The Achilles’ Heel of the Comprehensive Income Tax*, in *NEW DIRECTIONS IN FEDERAL TAX POLICY FOR THE 1980S* 278, 280 (Charls E. Walker & Mark A. Bloomfield eds., 1983).

income or its EPS, and also do not reduce a corporation's effective tax rate. The primary benefit of temporary differences, which may not be applicable in all cases, is to temporarily increase a corporation's cash flow—a feature that while certainly not unimportant, is not seen as significant a benefit to corporate management as increasing the corporation's net income or EPS.

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## I. INTRODUCTION

Many leading American tax law academics have written scholarly articles on tax deferral—some of which are considered the finest articles

ever written in the tax law literature.<sup>2</sup> For example, Professor Daniel Halperin's article, *Interest in Disguise: Taxing the 'Time Value of Money'*, which was published in the *Yale Law Journal* more than twenty years ago, is considered by many to be one of the two or three seminal articles in the area of taxation.<sup>3</sup>

It should come as no surprise that tax law academics have focused so intently on tax deferral and time value of money. Harvard Law Professor William Andrews wrote twenty-five years ago that deferral of gain "is not as serious as outright exemption, but it is the next best thing."<sup>4</sup> In other words, the best tax result for a taxpayer is to exclude an item of income (or gain) from taxation. For example, interest on a state or local bond is, as a general rule, excluded from taxation.<sup>5</sup> According to Professor Andrews, if exclusion is not possible, the next best result is to defer paying taxes on the item of income. In fact, with a long enough deferral period, the effective tax rate on an item of income may approach zero.<sup>6</sup> From a tax law standpoint, few academics would disagree that deferral is the next best thing to exclusion.

But how important is tax deferral in the real world, particularly with respect to Fortune 500 companies and other publicly held corporations?<sup>7</sup> In Corporate America, is tax deferral really that important? Should it be mentioned in the same breath as tax exemption? In this Article, I propose that, in Corporate America, tax exemption and tax deferral are worlds apart. Because of the accounting rules, tax exemption is a huge benefit to Corporate America. Corporate America highly covets tax exemptions, which it generally refers to as permanent differences. The accounting of permanent differences can increase net income and earnings per share (EPS), while reducing a corporation's effective tax rate. Tax deferral, however, confers a much smaller benefit to Corporate America, such that, in some cases, it becomes almost meaningless. Corporate America accepts tax deferral, which it refers to as temporary or timing differences, but, for

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2. See generally William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974); Daniel I. Halperin, *Interest in Disguise: Taxing the 'Time Value of Money'*, 95 YALE L.J. 506 (1986); Calvin H. Johnson, *Soft Money Investing Under the Income Tax*, 1989 U. ILL. L. REV. 1019 (1989); Stanley S. Surrey, *The Tax Reform Act of 1969—Tax Deferral and Tax Shelters*, 12 B.C. INDUS. & COM. L. REV. 307 (1971); Alvin C. Warren, *The Timing of Taxes*, 39 NAT'L TAX J. 499 (1986).

3. See Halperin, *supra* note 2. Professor Andrews's consumption tax article, *supra* note 2, is also generally regarded by tax scholars as one of the two or three seminal articles in the tax law literature.

4. Andrews, *supra* note 1, at 280.

5. I.R.C. § 103(a) (2006).

6. See *infra* Part IV.A (chart).

7. For purposes of this Article, the term "Corporate America" will refer to publicly held corporations that are required to file financial statements with the SEC.

the most part, devotes little time and resources in seeking out such items. In this Article, I discuss why Corporate America values permanent differences and also why, in some cases, it places such little value on temporary differences.

Several years ago, Edward Kleinbard, a leading tax practitioner and current chief of staff of the Joint Committee on Taxation, wrote that “the gap between tax policy academics and tax practice is too large, and probably growing larger.”<sup>8</sup> He wrote the statement in response to an academic article on tax deferral and its relation to the time value of money. This Article helps close the gap between tax policy academics and tax practice in the area of tax deferral and time value of money—arguably the most significant area of academic study in tax law.

Part II of this Article will provide some background in understanding financial accounting income and taxable income and explore some of the differences between the two.<sup>9</sup> In addition, this Part will provide some background on financial statements issued by publicly held corporations, and explain the importance of various components of the financial statements.

Parts III and IV of the Article will discuss permanent differences and temporary differences in detail and provide several examples of each type of difference.<sup>10</sup> The discussion will include an analysis of the advantages of permanent differences relative to temporary differences. Finally, Part V of the Article will discuss some of the benefits of temporary differences and why so many companies do not greatly value temporary differences.<sup>11</sup>

## II. BACKGROUND ON FINANCIAL INCOME

### A. General Principles

A publicly held corporation is required to compute its income for financial accounting purposes each year in accordance with generally accepted accounting principles (GAAP). The resulting income figure is generally referred to as pretax financial income.<sup>12</sup> The corporation will also compute its income tax expense for the year, which is subtracted from

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8. Edward D. Kleinbard, *Taxing Convertible Debt: A Layman's Perspective*, 56 SMU L. REV. 453, 453–54 (2003). In 1983, Kleinbard co-authored a leading article on time value of money. See Peter C. Canellos & Edward D. Kleinbard, *The Miracle of Compound Interest: Interest Deferral and Discount After 1982*, 38 TAX L. REV. 565 (1983).

9. See *infra* Part II.

10. See *infra* Parts III–IV.

11. See *infra* Part V.

12. “Pretax financial income” is sometimes referred to as income before taxes (or earnings before taxes), income for financial reporting purposes, or income for book purposes. See DONALD E. KIESO, ET AL., *INTERMEDIATE ACCOUNTING* 964 (12th ed. 2007) [hereinafter KIESO, ET AL.].

pretax financial income. This calculation results in the corporation's net income.<sup>13</sup> In addition, a corporation's income is generally subject to taxation by federal, most state, and several local taxing authorities. As a result, a corporation must also compute its income for tax purposes in accordance with the applicable tax statutes and regulations of various jurisdictions. The resulting income figure is referred to as taxable income.<sup>14</sup> In almost all cases, a corporation's taxable income will differ from its pretax financial income. In fact, the determinations of taxable income for Federal, State, and local jurisdictions will also almost always differ from each other. These differences primarily reflect the differing objectives behind the various taxing authorities and accounting rules.<sup>15</sup>

The tax rules are designed to provide equitable and efficient determination of tax liability and subsequent collection of revenue and also to provide incentives for corporations and individuals to engage in activities based upon the priorities and revenue needs of the various taxing authorities.<sup>16</sup> In contrast, the financial accounting rules are designed to paint a picture of the corporation's operations that is consistent in its measurement on both an annual basis and across entities so that creditors, shareholders, management, and any other properly interested persons can evaluate the absolute and relative performance of the corporation. The Financial Accounting Standards Board (FASB) wrote:

The objectives begin with a broad focus on information that is useful in investment and credit decisions; then narrow that focus to investors' and creditors' primary interest in the prospects of receiving cash from their investments in or loans to business enterprises and the relation of those prospects to the enterprise's prospects; and finally focus on information about an enterprise's economic resources, the claims to those resources, and changes in them, including measures of the

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13. For purposes of this Article, a corporation's net income is equal to its pretax financial income less its income tax expense.

14. See I.R.C. §§ 11, 63(a) (2006).

15. See *Thor Power Tool Co. v. Comm'r*, 439 U.S. 522, 542 (1979) ("The primary goal of financial accounting is to provide useful information to management, shareholders, creditors, and others properly interested; the major responsibility of the accountant is to protect these parties from being misled. The primary goal of the income tax system, in contrast, is the equitable collection of revenue; the major responsibility of the Internal Revenue Service is to protect the public fisc.").

16. See, e.g., MYRON S. SCHOLES, ET AL., *TAXES AND BUSINESS STRATEGY: A PLANNING APPROACH* 36 (3d ed. 2005); Michelle Hanlon, *What Can We Infer About a Firm's Taxable Income from Its Financial Statements?*, 56 NAT'L TAX J. 831, 833 (2003) [hereinafter Hanlon]; Gil B. Manzon, Jr. & George A. Plesko, *The Relation Between Financial and Tax Reporting Measures of Income*, 55 TAX L. REV. 175, 180 (2002) [hereinafter Manzon & Plesko].

enterprise's performance, that is useful in assessing the enterprise's cash flow prospects.<sup>17</sup>

Thus, while the rules for determining pretax financial income are fairly rigorous and based upon underlying economic assumptions and principles, the various taxing authorities have promulgated laws and regulations that do not necessarily follow rules grounded on the economic theories of financial reporting, but rather may be based on political, social, or economic objectives. In addition, the difference between a corporation's taxable income and its pretax financial income may be due to tax planning strategies, resulting in lower taxable income relative to pretax financial income.<sup>18</sup>

The differences between taxable income and pretax financial income create tax differences. Some of these differences are permanent differences and others are temporary differences (sometimes referred to as timing differences). Permanent differences generally relate to exemption items in the tax laws, while temporary differences generally relate to deferral items in the tax laws.

### B. *The Focus of Corporate Management*

Before discussing permanent differences and temporary differences in detail, summarizing the financial indicators that are critical to corporate management may help. The following is the first two paragraphs of a December 19, 2007 *Associated Press* story on Nike:

Nike Inc. reported 10-percent growth in its second-quarter profit, largely fueled by overseas sales growth for the athletic shoe and clothing company. Nike said second-quarter net income grew to \$359.4 million, or 71 cents a share, up from \$325.6 million, or 64 cents, in the same period a year earlier.<sup>19</sup>

As a general proposition, corporate management is extremely focused on the income statement. Often called the statement of income or statement of earnings, in business parlance it is usually referred to as the P & L statement (i.e., profit and loss statement). The income statement is the "report that measures the success of a company's operations for a

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17. See OBJECTIVES OF FINANCIAL REPORTING BY BUSINESS ENTERPRISES, Statement of Financial Accounting Concepts No. 1, §§ 32–33 (Fin. Accounting Standards Bd. 1978).

18. See Hanlon, *supra* note 16, at 833.

19. *Nike: Profits Increase 10% in 2nd Quarter*, OREGONIAN, Dec. 19, 2007, available at [http://blog.oregonlive.com/breakingnews/2007/12/nike\\_profits\\_increased\\_10\\_in\\_2.html](http://blog.oregonlive.com/breakingnews/2007/12/nike_profits_increased_10_in_2.html) (last visited Feb. 20, 2009).

given period of time.”<sup>20</sup> In looking at the income statement, several key items stand out. First, net income is viewed as the primary indicator of corporate management’s performance.<sup>21</sup> In the Nike news story, the *Associated Press* reported that Nike’s net income for the second quarter was \$359.4 million and compared that figure to Nike’s net income in the same period a year earlier.<sup>22</sup> In many cases, the board of directors of a publicly-held corporation will focus on the net income of the corporation in evaluating corporate management’s performance. Investors and analysts will also look at a company’s net income (and pretax financial income) in evaluating the company’s performance.<sup>23</sup>

Also, each quarter, corporate management tries to generate enough net income to meet or exceed the expectations of Wall Street so that the market price of the stock will increase.<sup>24</sup> One effect of an increasing stock price is an increase in the value of management’s stock options.<sup>25</sup> Generally, corporations prefer, if possible, to show steady growth each period in net income rather than wild swings in net income.<sup>26</sup> Attempting

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20. KIESO, ET AL., *supra* note 12, at 126.

21. *Id.* at 127 (“So far, our discussion has highlighted the importance of information in the income statement for investment and credit decisions, including the evaluation of the company and its managers.”); *id.* at 144 (“A company customarily sums up the results of its operations in one important figure: net income.”); *see also* BARRY J. EPSTEIN, ET AL., WILEY GAAP 2007: INTERPRETATION AND APPLICATION OF GENERALLY ACCEPTED ACCOUNTING PRINCIPLES 64 (2006) [hereinafter EPSTEIN, ET AL.] (“In financial reporting, performance is primarily measured by net income and its components, which are provided in the income statement.”).

22. *See supra* note 19.

23. A subset of pretax financial income is operating income, sometimes referred to as income from continuing operations. Operating income differs from pretax financial income in that the latter figure includes several additional items, such as discontinued operations and extraordinary items. *See* KIESO, ET AL., *supra* note 12, at 134–44. Another critical item on the income statement is revenues. Corporate management will, in almost all cases, focus on increasing revenues from period to period. In this Article, the difference between pretax financial income and operating income and the importance of growth in revenues is not particularly relevant in analyzing permanent and temporary differences, and, as a result, will not be discussed in detail.

24. Under the Securities and Exchange Act of 1934, publicly-traded companies, usually referred to as reporting companies, must file a quarterly report on Form 10-Q for each of the first three quarters of the company’s fiscal year. 17 C.F.R. § 249.308a(a) (2008). The Form 10-Q will contain the company’s financial statements showing the company’s financial results for the quarter. *Id.* A publicly-traded company must also file an annual report on Form 10-K. § 249.310(a). The Form 10-K will contain complete audited financial statements. § 240.13a-1. Most reporting companies do not file a Form 10-Q for their last fiscal quarter but include the last fiscal quarter’s financial results in the Form 10-K. *See* § 249.308a(a).

25. *See* KIESO, ET AL., *supra* note 12, at 127–28.

26. *See, e.g.*, STAFF OF J. COMM. ON TAXATION, 109TH CONG., PRESENT LAW AND BACKGROUND RELATING TO CORPORATE TAX REFORM: ISSUES OF CONFORMING BOOK AND TAX INCOME AND CAPITAL COST RECOVERY 17–18 (Comm. Print 2006).



to smooth out a corporation's net income from period to period is referred to as "earnings management."<sup>27</sup>

While corporate management focuses on net income, the financial world generally focuses on a corporation's earnings per share (EPS) as a financial indicator. In fact, EPS is considered the most significant business indicator in the financial world.<sup>28</sup> In the Nike news story, the *Associated Press* reported that Nike's EPS was 71 cents per share and compared that figure to Nike's performance a year earlier, when it reported 64 cents per share.<sup>29</sup> A corporation's EPS is equal to its net income or operating income available to common shareholders (less dividends on preferred stock) divided by the weighted average number of common shares of its stock outstanding.<sup>30</sup> Because EPS is calculated using the corporation's net income (and operating income), both EPS and net income are directly related (i.e., a higher net income will lead to a higher EPS). A corporation must disclose its EPS on the face of its income statement.<sup>31</sup>

A publicly-held corporation must also disclose its effective tax rate in the footnotes to its financial statements filed as part of Form 10-K.<sup>32</sup> This disclosure is referred to as the "tax footnote." Generally, a publicly held corporation wants its effective tax rate to be comparable to or lower than the industry average. More specifically, a corporation wants a lower

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27. See, e.g., CHRISTOPHER H. HANNA, ET AL., CORPORATE INCOME TAX ACCOUNTING 4.08 (2007) [hereinafter HANNA] (utilization of a charitable foundation to achieve earnings management); KIESO, ET AL., *supra* note 12, at 128 (stating that earnings management is "often defined as the planned timing of revenues, expenses, gains, and losses to smooth out bumps in earnings").

28. See, e.g., EPSTEIN, ET AL., *supra* note 21, at 926 ("Earnings per share (EPS) is an indicator widely used by both actual and prospective investors to gauge the profitability of a corporation."); KIESO, ET AL., *supra* note 12, at 144 ("However, the financial world has widely accepted an even more distilled and compact figure [than net income] as the most significant business indicator—earnings per share (EPS).").

29. *Supra* note 19.

30. EARNINGS PER SHARE, Statement of Financial Accounting Standards No. 128, §§ 8–10 (Fin. Accounting Standards Bd. 1997). A corporation computes its basic EPS using both net income and operating income resulting in two EPS figures. *Id.* § 9.

31. *Id.* § 36.

32. ACCOUNTING FOR INCOME TAXES, Statement of Financial Accounting Standards No. 109, § 47 (Fin. Accounting Standards Bd. 2008) [hereinafter ACCOUNTING FOR INCOME TAXES]. FASB requires that a public enterprise disclose a reconciliation of "(a) the reported amount of income tax expense attributable to continuing operations for the year to (b) the amount of income tax expense that would result from applying domestic federal statutory tax rates to pretax income from continuing operations." *Id.* In computing and disclosing this reconciliation, a public enterprise may use actual dollar amounts or percentages. *Id.*

A public enterprise will also disclose its estimated effective tax rate as part of Form 10-Q, which is filed quarterly with the SEC. ACCOUNTING FOR INCOME TAXES IN INTERIM PERIODS, Interpretation No. 18 (Fin. Accounting Standards Bd. 1977); INTERIM FINANCIAL REPORTING, APB Op. No. 28 (Accounting Principles Bd. 1973).

effective tax rate than its main competitors.<sup>33</sup> The effective tax rate is computed by dividing the corporation's income tax expense attributable to operating income by its operating income (sometimes referred to as "income from continuing operations").<sup>34</sup> The income tax expense includes current tax expense and deferred tax expense.<sup>35</sup> The deferred tax expense is computed based on a corporation's tax deferral items (i.e., its temporary differences). Because the tax effects of deferral items constitute deferred tax expense and therefore income tax expense, a corporation's effective tax rate is not affected by tax deferral items.<sup>36</sup>

### III. EXEMPTIONS AND PERMANENT DIFFERENCES

#### A. General Principles

In the Internal Revenue Code, Congress provides a number of exclusion provisions.<sup>37</sup> Income or gain falling within the exclusion provision is not taxed under the federal income tax laws. Some common examples of exclusion items include interest on state and local bonds;<sup>38</sup> proceeds of life insurance;<sup>39</sup> gifts, bequests, devises and inheritances;<sup>40</sup> gain on the sale of a principal residence;<sup>41</sup> personal injury damages;<sup>42</sup> and

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33. See, e.g., Martin A. Sullivan, *Reported Corporate Effective Tax Rates Down Since Late 1990s*, 118 TAX NOTES, Feb. 25, 2008, at 882, 882 ("Effective corporate tax rates, as reported to shareholders and to the Securities and Exchange Commission, play a critical role in a corporation's bottom line. The profit numbers universally cited in the financial press are after-tax figures, so corporate tax managers can contribute significantly to a corporation's reported profits by managing the effective tax rate."); Roger D. Wheeler, et al., *Session 7: Opportunities and Obstacles in Designing a U.S. Business Tax System for 2010 and Beyond*, TAXES, June 2008, at 115, 120 ("I used to be a corporate tax executive, and, you know, statutory rates, we had them, but I never focused on statutory rates very much. It was always the effective rates. That is sort of how you earned your stripes, you focused on that, you tried to do better than somebody else and getting your effective rate lower." (statement of Roger D. Wheeler)).

34. ACCOUNTING FOR INCOME TAXES, *supra* note 32, § 47. Operating income is a subset of pretax financial income.

35. *Id.* § 16 ("Total income tax expense or benefit for the year is the sum of deferred tax expense or benefit and income taxes currently payable or refundable."); *id.* § 45 (listing two significant components of income tax expense attributable to continuing operations for the year: current tax expense (or benefit) and deferred tax expense (or benefit)).

36. See *infra* Part IV.

37. See I.R.C. §§ 101–140 (2006) (listing a number of items specifically excluded from gross income).

38. *Id.* § 103(a).

39. *Id.* § 101(a)(1).

40. *Id.* § 102(a).

41. *Id.* § 121(a).

42. *Id.* § 104(a)(2).

various employee benefits.<sup>43</sup> In each case, Congress has some policy reason as to why the item in question is not taxed. The reasons are usually social, economic, or political. For example, in 1913, Congress enacted the state and local bond interest exemption based on the idea that taxing such income “would impose an unconstitutional burden on the borrowing power of state and local governments.”<sup>44</sup> Congress has retained the exclusion as a revenue sharing arrangement between the state and local governments.<sup>45</sup> Allowing the exclusion permits state and local governments to borrow at lower interest rates than taxable bonds of similar quality.<sup>46</sup>

When an item of income or gain is excluded from a corporation’s gross income<sup>47</sup> (and therefore excluded from taxable income), it leads to a difference between the corporation’s taxable income and its pretax financial income. More specifically, while excluded from taxable income, that item of income or gain is included in pretax financial income. As a result, pretax financial income is greater than taxable income by the excluded amount. For financial accounting purposes, the excluded amount is referred to as a permanent difference.

Permanent differences are items that (i) enter into pretax financial income but *never* into taxable income; or (ii) enter into taxable income but *never* into pretax financial income. As a result, these items create a difference between pretax financial income and taxable income that will not reverse over time. FASB has not defined permanent differences; however, in defining temporary differences, FASB wrote: “Some events do not have tax consequences. Certain revenues are exempt from taxation and certain expenses are not deductible. In the United States, for example, interest earned on certain municipal obligations is not taxable and fines are not deductible.”<sup>48</sup>

FASB appears to describe permanent differences as events that do not have tax consequences, with the two broad sub-categories being revenues

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43. *Id.* §§ 105, 106, 119, 127, 129, 132.

44. See 1 BORIS I. BITTKER & LAWRENCE LOKKEN, *FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS* ¶ 15.1.1 (3d ed. 1999) [hereinafter BITTKER & LOKKEN].

45. *Id.*

46. *Id.*

47. See I.R.C. § 61(a).

48. ACCOUNTING FOR INCOME TAXES, *supra* note 32, § 6 n.3. FASB has recently used the term “permanent difference” by writing “nontaxable or nondeductible differences between financial statements and tax returns (sometimes referred to as permanent differences).” ACCOUNTING FOR UNCERTAINTY IN INCOME TAXES, FASB Interpretation No. 48, § B11 (Fin. Accounting Standards Bd. 2006). The Accounting Principles Board, which was the predecessor to FASB, had defined a permanent difference as “[d]ifferences between taxable income and pretax accounting income arising from transactions that, under applicable tax laws and regulations, will not be offset by corresponding differences or ‘turn around’ in other periods.” ACCOUNTING FOR INCOME TAXES, APB Op. No. 11, § 13(f) (Accounting Principles Bd. 1967) [hereinafter APB Op. No. 11].

exempt from taxation and expenses that are not deductible. The first type of permanent difference enters into the computation of pretax financial income, but not taxable income. This difference is illustrated by Examples 1 and 2:

**Example 1.** A corporation owns some state and local bonds. It receives \$50,000 of interest on the bonds in 2007. Under the tax code, interest on state and local bonds is excluded from gross income and therefore never enters into the computation of taxable income.<sup>49</sup> However, such interest enters into the computation of financial income. As a result, a difference of \$50,000 is created in 2007 between taxable income and pretax financial income. This difference is permanent—it will not reverse over time. This is an example of a permanent difference that is favorable to the corporation.

**Example 2.** A publicly held corporation pays its chief executive officer a salary of \$1.4 million in 2007. The salary is not payable on a commission basis and is not performance-based compensation. The salary payment of \$1.4 million is an expense on the corporation's income statement; however, for tax purposes the corporation may only deduct \$1 million as a result of the limitation for certain excessive employee remuneration under I.R.C. § 162(m).<sup>50</sup> The \$400,000 difference between the \$1.4 million expense on the income statement and the \$1 million deduction on the tax return is a permanent difference, which enters into the computation of pretax financial income, but never into taxable income. This is an example of a permanent difference that is unfavorable to the corporation.

Some other common examples of items of permanent difference that enter into the computation of pretax financial income, but not taxable income include: expenses incurred in generating tax-exempt income,<sup>51</sup> the 50% limitation on deduction of meals and entertainment expenses,<sup>52</sup> fines and penalties resulting from a violation of law,<sup>53</sup> proceeds from life insurance carried by the enterprise on key employees,<sup>54</sup> and premiums paid

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49. I.R.C. § 103(a). In certain cases, interest on state and local bonds may be subject to tax under the alternative minimum tax. *Id.* § 57(a)(5) (treating interest on specified private activity bonds as a tax preference).

50. *Id.* § 162(m).

51. *Id.* § 265.

52. *Id.* § 274(n).

53. *Id.* § 162(f).

54. *Id.* § 101(a)(1).

for life insurance carried by the enterprise on key employees.<sup>55</sup>

The second type of permanent difference enters into the computation of taxable income but not pretax financial income. One common example is percentage depletion of natural resources in excess of their cost.<sup>56</sup> Another example is the dividends-received deduction for corporate recipients of dividends, as indicated in Example 3:<sup>57</sup>

**Example 3.** A corporation owns 2% of the stock of XYZ Corporation. During 2007, the corporation receives \$10,000 of dividends from XYZ Corporation. The corporation includes the \$10,000 of dividends in its pretax financial income and its taxable income. For tax purposes, the corporation is entitled to a 70% dividends-received deduction in computing its taxable income.<sup>58</sup> In computing its pretax financial income, however, the corporation simply includes the entire amount of the dividend resulting in a permanent difference of \$7,000 between taxable income and pretax financial income (equal to the amount of the dividends received deduction).

Moreover, permanent differences can be distinguished by whether they appear in the tax footnote.<sup>59</sup> A broader or narrower interpretation of permanent difference dictates the result. The broad interpretation of permanent differences includes any item that creates a difference between pretax financial income and taxable income that is not temporary.<sup>60</sup> A more narrow interpretation includes only items that create a difference between pretax financial income and taxable income that is not temporary and also appears in the effective tax rate reconciliation in the financial statements—i.e., the tax footnote.<sup>61</sup> For example, the expensing of nonqualified stock options may create an item that would be treated as a permanent difference under a broad interpretation of the term (i.e., a book-tax difference that is not temporary) but would not be treated as a permanent difference under the more narrow interpretation (i.e., it does not appear in the effective tax rate reconciliation). This contrast is illustrated in Example 4:

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55. *Id.* § 264(a)(1).

56. *Id.* § 613.

57. *Id.* §§ 243–246A.

58. *Id.* § 243.

59. See Lillian F. Mills & George A. Plesko, *Bridging the Reporting Gap: A Proposal for More Informative Reconciling of Book and Tax Income*, 56 NAT'L TAX J. 865, 873 n.9 (2003).

60. *Id.*

61. *Id.*

**Example 4.** A corporation grants non-qualified stock options to its employee on March 15, 2002. On the grant date, the fair market value of the stock is \$40 with an exercise price of \$40. On the exercise date of March 15, 2005, the stock is worth \$60. The corporation records a financial statement expense of \$15 in the grant year of 2002. When the employee exercises the stock option in 2005, the corporation takes a \$20 deduction (\$60 value of stock minus \$40 exercise price).<sup>62</sup> The \$15 stock option expense recorded on the financial statements in 2002 is a temporary difference that reverses in 2005, the year the corporation takes a tax deduction of \$20.<sup>63</sup> The \$5 excess of the \$20 tax deduction over the \$15 financial statement expense is a permanent difference under a broad interpretation of the term (i.e., a book-tax difference that is not temporary). However, the tax benefit of the \$5 excess does not appear in the effective tax rate reconciliation (i.e., tax footnote), but rather is credited as additional paid-in capital.<sup>64</sup>

Public companies that meet the reporting requirements of the Securities Exchange Act of 1934 must file Form 10-K.<sup>65</sup> The company must disclose its effective tax rate in the footnotes to their financial statements.<sup>66</sup> The effective tax rate shows either the percentage or dollar amount of taxes paid based on financial income.<sup>67</sup> Permanent differences may affect a company's effective tax rate and therefore its EPS. For example, assume a company receives an amount that it includes in revenues in computing its pretax financial income, but not in gross income in computing its taxable income. The item could reduce the company's effective tax rate and increase its EPS. In contrast, an amount that is not deductible for tax purposes, but is considered an expense in computing pretax financial

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62. I.R.C. § 83(h). The employee will have \$20 of compensation income upon exercising the nonqualified stock option. *Id.* § 83(a). The employee's inclusion of \$20 in gross income in 2005 permits the corporation a \$20 deduction in 2005. *Id.* § 83(h) (providing that the amount and timing of a corporation's deduction is linked to employee's gross income).

63. SHARE-BASED PAYMENT, Statement of Financial Accounting Standards No. 123, § 58 (Fin. Accounting Standards Bd. 2004) [hereinafter SHARE-BASED PAYMENT] (stating that a temporary difference based on the compensation expense is recognized for financial accounting purposes).

64. *Id.* § 62 (stating that if the tax deduction exceeds the compensation expense recognized for financial accounting purposes, then the tax benefit that exceeds the deferred tax asset is recognized as additional paid-in capital).

65. See 15 U.S.C. § 78m (2006).

66. ACCOUNTING FOR INCOME TAXES, *supra* note 32, § 47.

67. *Id.* Some companies show both percentages and dollar amounts in computing their effective tax rate.

income (such as a fine) will increase a company's effective tax rate and reduce its EPS.

**Example 5.** A corporation has pretax financial income of \$200,000 for 2005 and 2006. In 2005, it pays a non-deductible fine of \$10,000, and in 2006, it receives \$20,000 of tax-exempt interest that it includes in revenue but not gross income.

	2005	2006
Pretax financial income	\$200,000	\$200,000
Permanent differences:		
Non-taxable revenue	\$0	\$20,000
Non-deductible expense	\$10,000	\$0
Taxable income	\$210,000	\$180,000
Statutory tax rate	35%	35%
Total tax expense	\$73,500	\$63,000
Effective tax rate	36.75%	31.5%

The permanent differences impact the effective tax rate. The \$10,000 non-deductible fine in 2005 increased taxable income (relative to pretax financial income) thereby increasing current tax expense and therefore total income tax expense. Increasing the total income tax expense raised the effective tax rate to 36.75%, which is higher than the statutory tax rate of 35% in 2005. The \$20,000 non-taxed revenue decreased taxable income (relative to pretax financial income) thereby decreasing current tax expense and therefore total income tax expense. Decreasing the total income tax expense lowered the effective tax rate to 31.5%, which was lower than the statutory tax rate of 35% in 2006.<sup>68</sup>

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68. For purposes of this example, operating income is assumed to equal pretax financial income. This is an important assumption because the effective tax rate is determined based on the corporation's operating income and not its pretax financial income. As a result, some permanent differences may not impact the corporation's effective tax rate if the permanent difference merely affects pretax financial income and not operating income. See *supra* note 23 for a discussion of the difference between operating income and pretax financial income.

## B. Common Examples of Permanent Differences

### 1. Manufacturing Deduction<sup>69</sup>

As part of the American Jobs Creation Act of 2004, Congress enacted a tax deduction for qualified production activities.<sup>70</sup> When fully phased-in, this “manufacturing deduction” is equal to 9% of the lesser of: (a) qualified production activities income; or (b) taxable income (after the deduction for the utilization of any net operating loss carryforwards).<sup>71</sup> In addition, the deduction is limited to 50% of the W-2 wages paid by the taxpayer.<sup>72</sup>

When Congress considered enacting this deduction, a number of manufacturing companies lobbied to ensure that the manufacturing industry would receive a deduction and not a tax-rate cut (or a deduction that would be treated by FASB as a tax-rate cut).<sup>73</sup> These manufacturing companies preferred a deduction because they were in a net deferred tax asset position on their balance sheets.<sup>74</sup> A tax-rate cut would have forced

69. The manufacturing deduction under I.R.C. § 199 is not an exclusion provision; however, it has the same tax effect as an exclusion and is therefore utilized as an example of an exclusion that is a permanent difference. *See* I.R.C. § 199 (2006).

70. American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418, 1424 (2004).

71. I.R.C. § 199(a). The deduction is phased-in beginning in 2005. *Id.* For taxable years beginning in 2005 and 2006, the deduction is 3% of the lesser of (a) qualified production activities income; or (b) taxable income. *Id.* In 2007, 2008, and 2009, the percentage is increased to 6%. *Id.* For taxable years beginning in 2010, the deduction is fully phased-in with the percentage increasing to 9%. *Id.* § 199(a)(2).

72. *Id.* § 199(b).

73. In its bill, the House of Representatives provided that the corporate tax rate applicable to qualified production activities income may not exceed 32%. H.R. 4520, 108th Cong. § 102(a) (2004). As a result, the House wanted to enact a tax rate cut to benefit domestic manufacturers. In its bill, the Senate provided a deduction equal to a portion of the taxpayer’s qualified production activities income. S. 1637, 108th Cong. § 102 (2004). The Conference Committee adopted the deduction approach advocated by the Senate. *See* American Jobs Creation Act of 2004, H.R. 4520, 108th Cong. § 102 (2004) (enacted).

74. A corporation is in a net deferred tax asset position if its deferred tax assets exceed its deferred tax liabilities. Generally, this means that the corporation has, from a financial accounting standpoint, prepaid some of its future tax liabilities—the exact opposite of tax deferral.

Most publicly held corporations are in a net deferred tax liability position due primarily to depreciation deductions and leases. Those publicly held corporations that are in a net deferred tax asset position may have net operating loss or credit carryforwards, or the deferred tax assets may be due to employment or post-employment benefits. *See* James Poterba, et al., *The Significance and Composition of Deferred Tax Assets and Liabilities* (Unnumbered working paper, 2007), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=962750](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=962750) (“In 2004, 25 firms in a sample of 73 large corporations reported net deferred tax assets and 48 reported net deferred tax liabilities. Firms differ substantially in the composition of their deferred tax assets and liabilities. The largest components of deferred tax assets for sample firms are Loss and Credit Carryforwards and Employment and Post-employment Benefits. The largest components of deferred tax liabilities are



these companies to devalue their deferred tax assets and correspondingly increase their deferred tax expense.<sup>75</sup> Consequently, the companies would have shown less net income on their income statements in the year in which the tax rate cut was enacted.<sup>76</sup> Congress eventually enacted a deduction instead of a tax-rate cut, possibly due in part to the lobbying of the manufacturing companies.

**Example 6.** A corporation has a deferred tax asset of \$350 on its balance sheet,<sup>77</sup> which was recorded using a tax rate of 35%. If Congress reduces the corporate tax rate from 35% to 32%, then the corporation must revalue its deferred tax asset to \$320. This results in a \$30 increase to deferred tax expense thereby increasing total income tax expense for the year by \$30. As a result, the corporation's net income is reduced by \$30 due to the reduction in the corporate tax rate.

Shortly after the enactment of the manufacturing deduction, the FASB issued a staff position indicating its belief that the deduction should be accounted as a special deduction and not as a tax-rate reduction.<sup>78</sup> Treating the manufacturing deduction as a special deduction meant that it would create a permanent difference, i.e., a difference between pretax financial income and taxable income that will not reverse over time. If the FASB

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Property, Plant & Equipment and Leases. Total deferred tax assets for sample firms with net deferred tax assets in 2004 were \$61.9 billion, while total deferred tax liabilities for sample firms with net deferred tax liabilities were \$223.8 billion.”).

75. See ACCOUNTING FOR INCOME TAXES, *supra* note 32, § 27.

76. See *id.* Not only would the companies show less net income, but the adjustment due to a change in tax rates would lower operating income, another critical item on the income statement. *Id.* A corporation's operating income is used to compute its effective tax rate. *Id.* § 47.

In 1993, Congress increased the top corporate tax rate from 34% to 35%. Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, §§ 13221(a)(1)–(3) (1993). Those corporations in a net deferred tax asset position had to revalue their deferred tax assets upward with a corresponding decrease to deferred tax expense. See Kevin C. W. Chen & Michael P. Schoderbek, *The 1993 Tax Rate Increase and Deferred Tax Adjustments: A Test of Functional Fixation*, 38 J. ACCT. RES. 23, 23 (2000). As a result, those corporations in a net deferred tax asset position had a one-time positive adjustment to earnings as a result of the tax-rate increase. *Id.* at 26. Apparently, analysts reacted to the increase in earnings due to the tax rate adjustment in the same way they reacted to the other components of earnings (i.e., analysts did not disaggregate the earnings). *Id.* at 34.

77. The corporation has a deductible temporary difference of \$1,000 meaning that it either (a) included \$1,000 in gross income for tax purposes prior to including it in revenues for financial accounting purposes or (b) expensed \$1,000 for financial accounting purposes prior to deducting \$1,000 for tax purposes. See ACCOUNTING FOR INCOME TAXES, *supra* note 32, §§ 11, 13.

78. APPLICATION OF FASB STATEMENT NO. 109, ACCOUNTING FOR INCOME TAXES, TO THE TAX DEDUCTION ON QUALIFIED PRODUCTION ACTIVITIES PROVIDED BY THE AMERICAN JOBS CREATION ACT OF 2004, FASB Staff Position No. 109-1, § 4 (2004) [hereinafter FASB Staff Position No. 109-1].

staff had treated the deduction as a tax-rate reduction, then a corporation's existing deferred tax assets (and liabilities) would have been adjusted downward with a corresponding increase (or decrease) to deferred tax expense for the year. For a corporation in a net deferred tax liability position, treating the deduction as a tax-rate cut would have lowered the corporation's deferred tax expense and therefore increased its net income.<sup>79</sup> This one-time favorable result might have been favored by some corporations. By treating the manufacturing deduction as a special deduction, however, a corporation may reduce its effective tax rate in future years when its temporary differences, which created the deferred tax liabilities for the corporation, reverse in the future years.<sup>80</sup>

The FASB staff concluded that the manufacturing deduction is similar to other special deductions, such as statutory percentage depletion, because it is contingent upon the future performance of specific activities.<sup>81</sup> The following example depicts the deduction in action:

**Example 7.** A corporation has taxable income for the year 2008 (excluding the qualified production activities deduction) of \$22,000. Its qualified production activities income for the year 2008 is \$40,000, and its W-2 wages for 2008 is \$12,000. The statutory income tax rate is 35%. The corporation's qualified production activities deduction for 2008 is computed as 6% of the lesser of: (1) \$40,000 (qualified production activities income) or (2) \$22,000 (taxable income). This is equal to \$1,320, which is limited to 50% of the corporation's W-2 wages for 2008.

The corporation's deduction of \$1,320 creates a permanent difference between taxable income and pretax financial income.

## 2. Equity vs. Debt

A common issue that arises in tax law is whether an instrument issued by a corporation should be treated as equity or debt.<sup>82</sup> If the instrument is

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79. It would also have increased the corporation's operating income. See ACCOUNTING FOR INCOME TAXES, *supra* note 32, § 27.

80. See HANNA, *supra* note 27, at 2.11. The taxable temporary difference that created the deferred tax liability should reverse in a future year. When it does so, the corporation will reduce its deferred tax liability to zero with an offsetting increase to deferred tax benefit.

81. FASB Staff Position No. 109-1, *supra* note 78 (referencing ACCOUNTING FOR INCOME TAXES, *supra* note 32, §§ 231-32).

82. See, e.g., BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 4.02 (7th ed. 2000) [hereinafter BITTKER & EUSTICE]; David P. Hariton [hereinafter Hariton], *Distinguishing Between Equity and Debt in the New Financial*

treated as equity for tax purposes, then any payments made by the corporation to the holder of the instrument are treated as a dividend.<sup>83</sup> If, however, the instrument is treated as debt for tax purposes, then any payment made to the holder of the instrument is treated as interest.<sup>84</sup> The obvious corporate advantage of treating the instrument as debt rather than equity for tax purposes is that interest payments are deductible, while dividends are not.<sup>85</sup>

In recent years, many corporations have issued hybrid instruments where payments are treated as interest for tax purposes but distributions on equity for financial accounting purposes.<sup>86</sup> This characterization achieves, in a sense, the best of both worlds. Treating the instrument as debt for tax purposes provides the corporation with an interest deduction for the payments on the instrument. Treating the instrument as equity for financial accounting purposes provides the corporation with a stronger balance sheet by showing less debt.<sup>87</sup> Such characterizations for tax and financial accounting purposes may create a permanent difference between taxable income and pretax financial income.<sup>88</sup>

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*Environment*, 49 TAX L. REV. 499, 499–500 (1994); William T. Plumb, Jr., *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 TAX L. REV. 369, 369–71 (1970).

83. I.R.C. § 316 (2006).

84. *Id.* § 163(a).

85. *Id.* (providing deduction for interest accrued or paid during the taxable year).

86. See, e.g., I.R.S. Notice 94-47, 1994-19 I.R.B. 9 (provides eight factors in determining whether an instrument should be treated as equity or debt for tax purposes); I.R.S. Notice 94-48, 1994-19 I.R.B. 10; I.R.S. Tech. Adv. Mem. 1999-10-046 (Mar. 12, 1999) (applying the eight-factor test in Notice 94-47 to preferred securities); BITTKER & EUSTICE, *supra* note 82, at 4.03 (“[F]inancial planners have devised a bewildering variety of fence-straddling securities (also known as innovative financial products) that, although by no means innocent of tax motivations, seek to meet genuine business objectives achievable only by abandoning the historic distinction between the terms ‘pure debt’ and ‘pure equity.’”); Hariton, *supra* note 82, at 518 (noting that monthly income preferred securities (MIPS) are treated as minority interest equity but distributions reduce earnings as much as interest payments; hence, earnings per share (EPS) is not affected).

87. Hybrid instruments also may provide a benefit to corporate issuers for credit rating purposes, because private rating agencies, such as Standard & Poor’s and Moody’s, use gradations between the two extremes of equity and debt.

88. In May 2003, FASB issued ACCOUNTING FOR CERTAIN FINANCIAL INSTRUMENTS WITH CHARACTERISTICS OF BOTH LIABILITIES AND EQUITY, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 150 (Fin. Accounting Standards Bd. 2003). FASB provided that certain financial instruments, such as MIPS, that have characteristics of both liabilities and equity (and have been presented either as equity or between the liabilities section and the equity section of the balance sheet) will be treated as a liability. In addition, payments of dividends on such financial instruments must be reported as interest costs. See Shai Levi & Benjamin Segal, *The Impact of Debt-Equity Reporting Classification on Firms’ Decision to Issue Hybrid Securities* (Unnumbered working paper, 2005), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=861685](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=861685).

**Example 8.** A corporation has \$100 million of taxable income and pretax financial income in 2007. Additionally, in 2007, it pays \$10 million on an instrument, which it characterizes as debt for tax purposes and equity for financial accounting purposes. The \$10 million payment will reduce taxable income to \$90 million. However, pretax financial income will remain at \$100 million if, for financial accounting purposes, the \$10 million payment is treated as a dividend. As a result, a permanent difference of \$10 million is created.

### 3. Research Credit

In 1981, Congress enacted a research credit because it believed that “a substantial tax credit for incremental research and experimental expenditures [would] overcome the resistance of many businesses to bear the significant costs of staffing, supplies, and certain computer charges which must be incurred in initiating or expanding research programs.”<sup>89</sup> Congress has never made the credit permanent law but has rather renewed the credit continuously since 1981.<sup>90</sup> Currently, the credit has been renewed through December 31, 2009.<sup>91</sup>

The amount of the research credit is equal to 20% of the excess of the qualified research expenses for the taxable year over the base amount.<sup>92</sup> “Qualified research” is defined as research incurring expenditures treatable as expenses under § 174, which is undertaken to discover information that is technological in nature, and the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and substantially all of the activities of which constitutes elements of a process of experimentation for a particular purpose (i.e., a new or improved function, performance, or reliability or quality).<sup>93</sup> “Qualified research expenses” is the sum of in-house research expenses and contract research expenses.<sup>94</sup> The base amount is the greater of the fixed-base percentage times the average annual gross receipts for the preceding four taxable years, or 50% of the qualified research expenses for the year.<sup>95</sup> As a result, the maximum credit is 10% of “qualified research

89. H.R. REP. NO. 97-201, pt. 1, at 106 (1981).

90. GARY GUENTHER, CRS REPORT FOR CONGRESS: RESEARCH TAX CREDIT: CURRENT STATUS, LEGISLATIVE PROPOSALS IN THE 109TH CONGRESS, AND POLICY ISSUES, at 10, 13 (2006).

91. I.R.C. § 41(h)(1) (West 2008).

92. I.R.C. § 41(a)(1) (2006).

93. *Id.* § 41(d)(1), (3).

94. *Id.* § 41(b)(1)–(3).

95. *Id.* § 41(c). The fixed base percentage is generally the lesser of 16% or the ratio of aggregate qualified research expenses of the taxpayer for the years 1984 to 1988 to the aggregate gross receipts for those years. *Id.* § 41(c)(3). A special rule applies for start-up companies. *Id.*

expenses (20% of the excess of qualified research expenses over 50 percent thereof).”<sup>96</sup>

A taxpayer may not deduct or capitalize research costs to the extent of the research credit allowed to the taxpayer.<sup>97</sup> For example, if a corporation has \$10,000 of qualified research expenses and is allowed a research credit of \$1,000, then it may only deduct \$9,000 of research costs. Alternatively, a taxpayer may elect to preserve its deduction by reducing its research credit by the amount of the credit multiplied by the maximum corporate tax rate of 35%.<sup>98</sup> Therefore, if the corporation has \$10,000 of qualified research expenses and is allowed a research credit of \$1,000, it may elect to reduce its credit to \$650 (\$1,000 less (\$1,000 times 35%)) and thereby deduct the entire \$10,000 research costs. For financial accounting purposes, a corporation expenses its research and development costs as they are incurred.<sup>99</sup> As a result, the research credit is a permanent difference because it is an item provided for in the tax laws with no counterpart in the financial accounting rules.

**Example 9.** A corporation has \$1 million of qualified research expenses and is allowed a research credit of \$100,000. The corporation elects to reduce the credit by \$35,000 (\$100,000 times 35%) so that its research credit is only \$65,000 for the year. As a result of the election, the corporation is allowed to deduct the entire \$1 million of qualified research expenses. The corporation will also expense the \$1 million of qualified research expenses for financial accounting purposes. The research credit of \$65,000 is a permanent difference.

#### IV. TAX DEFERRAL AND TEMPORARY DIFFERENCES

##### A. General Principles

Academics and practitioners commonly analogize tax deferral to an interest-free loan from the government to the taxpayer.<sup>100</sup> The U.S.

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§ 41(c)(3)(B).

96. See BITTKER & LOKKEN, *supra* note 44, at ¶ 27.4.2.

97. I.R.C. § 280C(c)(1)–(2).

98. *Id.* § 280C(c)(3).

99. ACCOUNTING FOR RESEARCH AND DEVELOPMENT COSTS, Statement of Financial Accounting Standards No. 2, § 12 (Fin. Accounting Standards Bd. 1974).

100. Some other views of tax deferral include the percentage exclusion view and the yield exemption view. For purposes of this Article, it is not relevant what view of tax deferral is utilized. For a discussion of the various views of tax deferral, see, for example, MICHAEL J. GRAETZ & DEBORAH H. SCHENK, *FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES* 290–94 (5th ed. 2005); CHRISTOPHER H. HANNA, *COMPARATIVE INCOME TAX DEFERRAL: THE UNITED STATES AND*

government has certainly viewed tax deferral in this manner. For example, in November 1984, the Treasury Department released a report describing tax deferral as the “Federal Government effectively provid[ing] to the taxpayer an interest-free loan equal to the deferred tax liability. The value of tax deferral is greater, the longer the deferral and the higher the taxpayer’s marginal tax rate.”<sup>101</sup> The Treasury then provided the following chart showing the effective tax rate per dollar of income deferred by a taxpayer in the 50% marginal tax bracket.<sup>102</sup>

Interest rate	Effective Tax Rate					
	1-year Deferral Period	3-year Deferral Period	5-year Deferral Period	10-year Deferral Period	20-year Deferral Period	30-year Deferral Period
4%	48.1%	44.4%	41.1%	33.8%	22.8%	15.4%
6%	47.2%	41.0%	37.4%	27.9%	15.6%	8.7%
8%	46.3%	39.7%	34.0%	23.2%	10.7%	5.0%
10%	45.4%	37.6%	31.0%	19.3%	7.4%	2.9%
12%	44.6%	35.6%	28.4%	16.1%	5.2%	1.7%

As the chart demonstrates, at a 6% interest rate, a ten-year deferral period effectively reduces a 50% marginal tax rate to only 27.9%.<sup>103</sup> If the interest rate is 12% and the deferral period is 30 years, then a 50% marginal tax rate is effectively reduced to 1.7%, almost equivalent to complete exclusion.

In the Code, Congress has provided a number of tax deferral provisions. Generally, a deferral provision falls into one of two categories: (1) an item of income or gain that is not currently taxed, but rather is taxed in a later year, or (2) a deduction or loss that is accelerated from a future year to the current year.<sup>104</sup> In both cases, a tax savings is achieved for the current year with an offsetting increase in taxes in a later year.<sup>105</sup> However, even with constant tax rates, the taxpayer benefits from the deferral

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JAPAN 13–28 (2000) [hereinafter COMPARATIVE INCOME TAX DEFERRAL]; STANLEY S. SURREY, PATHWAYS TO TAX REFORM: THE CONCEPT OF TAX EXPENDITURES 120–25 (1973).

101. See TREASURY DEP’T, REPORT TO THE PRESIDENT ON TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH 126, 129 (1984) (“Charging interest on the amount of the deferred tax liability for taxpayers electing the installment method would make the tax law neutral as to the financing of property sales and would end use of installment sales as a vehicle for tax deferral.”).

102. *Id.* at 127.

103. The formula for computing the effective tax rate in the table provided by the Treasury Department is:  $T/(1+i)^n$  where:  $T$  = tax rate,  $i$  = interest rate, and  $n$  = years in the deferral period.

104. See, e.g., COMPARATIVE INCOME TAX DEFERRAL, *supra* note 100, at 1.

105. Christopher H. Hanna, *Tax Theories and Tax Reform*, 59 SMUL REV. 435, 442 (2006).

because of the time value of money.<sup>106</sup> In other words, the taxpayer can invest the immediate tax savings so that when he repays the offsetting increase in taxes in a later year, he will still have some amount of the invested taxes left over.<sup>107</sup> Some common examples of deferral provisions in the tax laws include accelerated depreciation,<sup>108</sup> § 179 expensing,<sup>109</sup> the installment method for reporting gain from an installment sale,<sup>110</sup> unrealized appreciation in property,<sup>111</sup> and foreign source income of a foreign subsidiary of a U.S. parent corporation.<sup>112</sup>

Deferring income or gains from a corporation's gross income (and therefore taxable income) may lead to a current difference between the corporation's taxable income and its pretax financial income.<sup>113</sup> More specifically, while deferred from taxable income, that item of income or gain may be included in pretax financial income.<sup>114</sup> As a result, pretax financial income is greater than taxable income by the deferred amount. In a later year, however, when the deferred amount is included in gross income (and therefore taxable income), taxable income will be greater than pretax financial income by the deferred amount.<sup>115</sup> As a result, the deferred amount creates a temporary difference between taxable income and pretax financial income, which reverses in a later year when the deferred amount is included in taxable income.<sup>116</sup> For financial accounting purposes, the deferred amount is referred to as a temporary difference, and is often referred to by practitioners as a timing difference.<sup>117</sup>

The FASB defines a temporary difference as occurring when the tax basis of an asset or liability differs from its financial reporting basis (i.e., book basis).<sup>118</sup> For example, assume a corporation purchases equipment

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106. *Id.*

107. *Id.*

108. I.R.C. § 168 (2006).

109. *Id.* § 179.

110. *Id.* § 453.

111. *Id.* § 1001.

112. *Id.* § 11(d).

113. See ACCOUNTING FOR INCOME TAXES, *supra* note 32, at §§ 10, 11.

114. See *id.*

115. *Id.* at §§ 12, 13.

116. *Id.*

117. In 1967, the Accounting Principles Board (APB) issued Opinion No. 11 entitled, *Accounting for Income Taxes*. In the opinion, the APB defined a timing difference as “[d]ifferences between the periods in which transactions affect taxable income and the periods in which they enter into the determination of pretax accounting income. Timing differences originate in one period and reverse or ‘turn around’ in one or more subsequent periods.” APB Op. No. 11, *supra* note 48, § 13(e). Although APB Op. No. 11 has been superseded by FAS No. 109, some practitioners still use the term “timing difference” in describing a “temporary difference.”

118. ACCOUNTING FOR INCOME TAXES, *supra* note 32, § 289. If a corporation's tax basis in an asset is greater than its book basis in the asset, a deductible temporary difference is created

for \$100,000 and immediately places it in service. In the first year, assume the corporation's depreciation deduction for tax purposes is \$20,000 but its depreciation expense for financial accounting purposes is only \$15,000.<sup>119</sup> As a result, the tax basis of the equipment is \$80,000 (\$100,000 less \$20,000 of tax depreciation) at the end of year one and its book basis is \$85,000 (\$100,000 less \$15,000 of book depreciation). Because the tax basis differs from the book basis, a temporary difference of \$5,000 has arisen. This temporary difference will reverse and be eliminated as the equipment becomes fully depreciated, at which time its tax basis and book basis will both be zero.

### B. *Common Examples of Tax Deferral Provisions and Temporary Differences*

The Code contains a number of tax deferral provisions, which are almost always temporary differences under the financial accounting rules. Three common tax deferral provisions will be discussed: installment sales of property, accelerated depreciation for equipment, and foreign source income of foreign subsidiaries of U.S. parent corporations.

#### 1. Installment Sales of Property

Under the Code, a taxpayer that makes an installment sale of property at a gain may recognize the gain in gross income under the installment method.<sup>120</sup> An installment sale arises when property is sold at a gain and at least one payment is due after the close of the year in which the sale occurred.<sup>121</sup> Congress enacted the installment sale rules in 1926, when arguably tax deferral and time value of money were not widely recognized issues.<sup>122</sup> In more recent times, academics have discussed the tax deferral

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resulting in a deferred tax asset. *Id.* § 5. If a corporation's tax basis in an asset is less than its book basis in the asset, a taxable temporary difference is created resulting in a deferred tax liability. *Id.*

119. The difference between the amount of the depreciation deduction and the depreciation expense may be due to the use of an accelerated method of depreciation for tax purposes and the straight-line method of depreciation for financial accounting purposes, the use of a longer recovery period for financial accounting purposes than for tax purposes, or a different placed-in-service date for financial accounting purposes than for tax purposes.

120. I.R.C. § 453(a) (2006). In fact, the installment method is mandatory unless the taxpayer elects for it not to apply. *Id.* § 453(d).

121. *Id.* § 453(b)(1).

122. Revenue Act of 1926, ch. 27, § 212(d), 44 Stat. 9, 23 (1926). The Supreme Court explained the purpose for the enactment of the installment sale method:

[T]o relieve taxpayers who adopted it from having to pay an income tax in the year of sale based on the full amount of anticipated profits when in fact they had received in cash only a small portion of the sales price. Another reason was the



benefits of the installment sale rules.<sup>123</sup> Assume a corporation makes an installment sale of property with a basis of \$200,000 and a sales price of \$1 million.<sup>124</sup> The buyer will pay \$500,000 down and an additional \$500,000 (with interest) in one year. The corporation recognizes a gain of \$400,000 in year one and an additional \$400,000 of gain in year two.<sup>125</sup> Assuming a 35% corporate tax rate, the corporation pays \$140,000 (\$400,000 gain times 35%) of taxes in year one and an additional \$140,000 of taxes in year two. The corporation has deferred paying taxes of \$140,000 for one year. This deferral can be viewed as the government loaning the corporation \$140,000 for one year with no interest due.<sup>126</sup>

For financial accounting purposes, the corporation's pretax financial income remains unchanged as a result of the corporation's use of the installment method for tax purposes. Under the financial accounting rules, a corporation is generally not permitted to use the installment method in computing its pretax financial income.<sup>127</sup> It must report the entire amount of gain at the time of sale. Therefore, in the above example, the corporation will report the entire \$800,000 of gain in revenue in the year of sale regardless of whether the corporation uses the installment method for tax purposes.

In measuring net income, income tax expense is an item that is aggregated with other expenses, then subtracted from total revenues, in

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difficult and time-consuming effort of appraising the uncertain market value of installment obligations.

*Comm'r v. S. Tex. Lumber Co.*, 333 U.S. 496, 503 (1948).

123. See, e.g., Martin D. Ginsburg, *Teaching Tax Law After Tax Reform*, 65 WASH. L. REV. 595, 617 (1990); Daniel I. Halperin, *The Time Value of Money—1984*, 23 TAX NOTES 751, 754 (1984); Christopher H. Hanna, *The Virtual Reality of Eliminating Tax Deferral*, 12 AMER. J. TAX POL'Y 449, 455 (1995); Lee A. Sheppard, *Ginsburg Discusses Taxing the Privilege of Tax Deferral in Installment Sales*, 27 TAX NOTES 457, 457–58 (1985).

124. In 1987, Congress enacted I.R.C. § 453A, imposing an interest charge on the tax being deferred under the installment method and, in a sense, recognizing that the seller of the property is, in essence, receiving an interest-free loan from the government. I.R.C. § 453A. See generally Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, 101 Stat. 1330 (1987). The interest charge only applies, however, on installment obligations arising from the sale of property, if the total amount of installment obligations that arose during the year and were outstanding at the end of the year exceeded \$5 million. I.R.C. § 453A(b). See generally Christopher H. Hanna & Samuel Olchyk, *Interest Under Section 453A(c): Is It or Isn't It?*, 56 TAX NOTES 1345 (1992).

125. In computing the amount of gain recognized each year, the corporation must compute the selling price, total contract price, gross profit, and gross profit ratio from the installment sale. See Treas. Reg. § 15a.453-1(b)(2) (2008).

126. See *supra* note 101 and accompanying text.

127. See OMNIBUS OPINION, APB Op. No. 10, § 12 (Accounting Principles Bd. 1966) [hereinafter OMNIBUS OPINION] (except in special circumstances, "the installment method of recognizing revenue is not acceptable."); see also EPSTEIN, ET AL., *supra* note 21, at 755; KIESO, ET AL., *supra* note 12, at 924.

arriving at net income. Because the corporation only pays taxes in year one on \$400,000 of gain, it appears that the income tax expense for year one will only reflect \$140,000 of taxes (\$400,000 of gain times 35% tax rate). However, the \$400,000 of gain recognized for tax purposes in year two is a temporary difference. As a result, the corporation will record a deferred tax liability of \$140,000 (\$400,000 temporary difference times 35% tax rate) in year one to reflect the fact that it will pay the \$140,000 of taxes in year two. In recording the deferred tax liability of \$140,000, the corporation will also, in year one, show deferred tax expense of \$140,000, which when added to the current tax expense of \$140,000 in year one equals the income tax expense for year one of \$280,000. Consequently, the deferral of \$140,000 of taxes from year one to year two does not increase net income for the corporation in year one.<sup>128</sup> The corporation will report net income of \$520,000 in year one (\$800,000 gain less \$280,000 of income tax expense) even if the gain is recognized in gross income for tax purposes over two years through use of the installment method. In other words, for financial accounting purposes, it is as if the entire gain was taxed in year one.

	Income Statement (Installment Method Used for Tax Purposes)	Income Statement (Installment Method Not Used for Tax Purposes)
Revenues:		
Gain	\$800,000	\$800,000
Expenses:		
Current Tax Expense	\$140,000	\$280,000
Deferred Tax Expense	\$140,000	\$0
Net Income	\$520,000	\$520,000

As previously stated, corporate management is focused on net income, EPS, and effective tax rates. The corporation's use of the installment method for tax purposes did not affect its net income for the year of sale of the property, which remained unchanged at \$520,000. Since EPS is computed based on net income for the year, the corporation's use of the installment method also has no affect on its EPS for the year of sale of the property. If, for example, the corporation had 100,000 shares of stock outstanding, its EPS would have been \$5.20 (\$520,000 net income divided by 100,000 shares) whether or not the installment method was used for tax

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128. FASB addressed the issue of discounting deferred taxes to present value but determined not to do so, instead noting that the APB Op. No 10 addressed the subject. ACCOUNTING FOR INCOME TAXES, *supra* note 32, § 5(b). For a detailed discussion of discounting, see *infra* Part V.

purposes. As a result, the key business indicator in the financial world is unaffected by a temporary difference (i.e., use of the installment method for tax purposes).<sup>129</sup>

Corporate management is also focused on the corporation's effective tax rate, which is computed by dividing the corporation's income tax expense by its operating income. In the above example, operating income is assumed to equal net income before income tax expense, or more simply pretax financial income. Therefore, operating income is equal to \$800,000 (\$520,000 net income plus income tax expense of \$280,000). The effective tax rate is equal to \$280,000 (income tax expense) divided by \$800,000 (operating income), or 35%. The 35% effective tax rate, which the corporation will disclose in a footnote to its financial statements filed with Form 10-K, is unchanged whether or not the installment method was used for tax purposes. In other words, temporary differences also do not affect a corporation's effective tax rate. The reason is that temporary differences create deferred taxes that are included in income tax expense along with current tax expense.

## 2. Accelerated Depreciation for Equipment

Under the Code, a corporation may depreciate tangible personal property under an accelerated method of depreciation.<sup>130</sup> The general rule is the 200% declining balance method of depreciation, sometimes referred to as the double declining balance method of depreciation.<sup>131</sup> If a corporation elects, it may instead use the 150% declining balance method or the straight-line method of depreciation.<sup>132</sup> For financial accounting purposes, a corporation will typically use the straight-line method of depreciation for two reasons: (1) it results in a greater amount of pretax financial income (at least in the early years of the depreciable asset) as opposed to an accelerated depreciation method, and (2) it is simple to use.

Similar to the installment method, accelerated depreciation merely creates a temporary difference between pretax financial income and taxable income. For example, assume a corporation purchases equipment for \$1 million (and places it in service) on January 1, 2006. It uses accelerated depreciation for tax purposes (200% declining balance with the half-year convention) and straight-line depreciation for financial accounting purposes, in both cases, over a five-year recovery period or useful life. The following table shows the depreciation expense,

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129. Temporary differences may impact a corporation's EPS in future years. *See infra* Part V.B.

130. I.R.C. § 168 (2006).

131. *See id.* § 168(b)(1).

132. *Id.* § 168(b)(2)(C), (b)(3)(D).

depreciation deduction, book basis of the equipment, and tax basis of the equipment each year.

Year	(a) Depreciation Expense (Accounting)	(b) Depreciation Deduction (Tax)	(c) Difference ((a)–(b))	(d) Book Basis	(e) Tax Basis	(f) Difference ((d)—(e))
2006	\$200,000	\$200,000	\$0	\$800,000	\$800,000	\$0
2007	\$200,000	\$320,000	(\$120,000)	\$600,000	\$480,000	\$120,000
2008	\$200,000	\$192,000	\$8,000	\$400,000	\$288,000	\$112,000
2009	\$200,000	\$115,200	\$84,800	\$200,000	\$172,800	\$27,200
2010	\$200,000	\$115,200	\$84,800	\$0	\$57,600	(\$57,600)
2011	\$0	\$57,600	(\$57,600)	\$0	\$0	\$0

In 2006, the tax and book depreciation are the same. But in 2007, the corporation has \$120,000 *more* of tax depreciation deduction than book depreciation expense with respect to the equipment. The tax basis of the equipment is \$120,000 lower than the book basis of the equipment creating a temporary difference of \$120,000. As a result, in 2007, the corporation will record a deferred tax liability of \$42,000 (\$120,000 times 35%) with a corresponding increase to deferred tax expense of \$42,000.

Assume in 2007, the corporation has revenues of \$20 million and its only expenses were depreciation and income taxes. The following table shows the corporation's income statement for 2007 using accelerated depreciation or straight-line depreciation for tax purposes:

	Income Statement (Accelerated Depreciation Used for Tax Purposes)	Income Statement (Straight- Line Depreciation Used for Tax Purposes)
Revenues:	\$20,000,000	\$20,000,000
Expenses:		
Depreciation Expense	\$200,000	\$200,000
Operating Income	\$19,800,000	\$19,800,000
Current Tax Expense	\$6,888,000	\$6,930,000
Deferred Tax Expense	\$42,000	\$0
Net Income	\$12,870,000	\$12,870,000

The corporation's net income will be the same whether it uses accelerated or straight-line depreciation for tax purposes. The reason is that the tax benefit from the excess of accelerated depreciation over straight-line depreciation is recorded for financial accounting purposes as a deferred tax liability of \$42,000 with a corresponding increase to deferred tax expense. As a result, the corporation's net income remains at

\$12,870,000 for 2007. The corporation's EPS will also be the same whether it uses accelerated or straight-line depreciation for tax purposes.

In addition, the corporation's effective tax rate is also unaffected by use of accelerated depreciation for tax purposes. In the above example, operating income (and pretax financial income) is \$19.8 million. The effective tax rate is \$6.93 million (income tax expense) divided by \$19.8 million (operating income), or 35%. The effective tax rate is 35% whether or not the corporation uses an accelerated depreciation method for tax purposes. As a result, accelerated depreciation does not increase a corporation's net income or its EPS and does not lower a corporation's effective tax rate.

### 3. Foreign Source Income of a Foreign Subsidiary of a U.S. Corporation

If a U.S. corporation wants to conduct business abroad, in many cases it will form a corporation in the foreign country where the business will be conducted. For example, if a U.S. corporation wants to conduct business in Brazil, it will typically form a Brazilian corporation to conduct its Brazilian business rather than merely establishing a branch in Brazil. The income of the foreign corporation is not subject to U.S. taxation unless part or all of that income was earned in the United States.<sup>133</sup> Assuming that it was not, the income will not be taxed by the United States until the foreign corporation repatriates the income, typically by way of dividends, to its U.S. parent corporation.<sup>134</sup> When the foreign subsidiary does so, the U.S. will tax the U.S. parent on those dividends at the time it receives them. In addition, the U.S. parent will be entitled to credit the foreign taxes paid by its foreign subsidiary against the U.S. taxes that arise as a result of the repatriation.<sup>135</sup>

Because the income of the foreign subsidiary is not taxed to the U.S. parent until the income is repatriated, the U.S. parent defers paying U.S. income taxes on the income of its foreign subsidiary. The deferral period could last for many years—until repatriation or the sale or other disposition of the stock of the foreign subsidiary. This deferral is a tremendous tax advantage to the U.S. parent. Consequently, Congress has enacted a number of anti-deferral regimes, which primarily target passive, mobile types of income.<sup>136</sup> If an anti-deferral regime is applicable to some

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133. *Id.* § 11(d) (providing that a foreign corporation is taxed by the U.S. as provided in § 882, which generally taxes only the U.S. source income of foreign corporations).

134. *See id.* § 61(a)(7) (providing that gross income includes dividend income).

135. *Id.* § 78 (providing gross-up of the dividend to include the foreign income taxes); § 902 (providing indirect foreign tax credit).

136. *See id.* §§ 531–537 (dealing with accumulated earnings tax); §§ 541–547 (stating personal holding company rules); §§ 951–965 (targeting subpart F income of controlled foreign

or all of the income of a foreign subsidiary, then generally that income will flow through to the U.S. parent.<sup>137</sup> Some commentators have recommended enacting a pass-through regime so that all income of a foreign subsidiary will flow through to the U.S. parent—not just the passive, mobile type of income.<sup>138</sup> Enactment of such a pass-through regime is unlikely in the near future with respect to income of foreign subsidiaries.<sup>139</sup>

Publicly-held corporations view the tax deferral of income of foreign subsidiaries, as extremely important, but not solely for the time value of money benefits of the deferral. Ownership can confer other advantages. Under the financial accounting rules, if a corporation owns 20% or more of another corporation (whether domestic or foreign), then the investor corporation is treated as having “significant influence” over the investee corporation.<sup>140</sup> The investor corporation will account for its investment in the investee corporation under the equity method of accounting, which treats the income of the investee corporation as flowing through to the investor corporation.<sup>141</sup> If the investor corporation owns more than 50% of the investee corporation, then the investor corporation is referred to as the

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corporations); §§ 1291–1298 (stating passive foreign investment company rules targeting offshore mutual funds). Congress has recently repealed, as part of the American Jobs Creation Act of 2004, two other taxing regimes targeting passive types of income of foreign corporations: §§ 551–558, dealing with foreign personal holding companies, and §§ 1246–1247, dealing with foreign investment companies. *See generally* American Jobs Creation Act of 2004, Pub. L. 108-357, § 413, 118 Stat. 1418, 1506 (2004).

137. *See, e.g.*, I.R.C. § 951 (including subpart F income as flowing through to the U.S. shareholder); § 1293 (including income of qualified electing fund as flowing through to U.S. person).

138. *See generally* J. Clifton Fleming Jr. & Robert J. Peroni, *Exploring the Contours of a Proposed U.S. Exemption (Territorial) Tax System*, 109 TAX NOTES 1557 (2005); Robert J. Peroni, et al., *Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income*, 52 SMU L. REV. 455 (1999); Stephen E. Shay, *Revisiting U.S. Anti-Deferral Rules*, 74 TAXES 1042 (1996).

139. In 2005, both the President’s Advisory Panel and the Staff of the Joint Committee on Taxation proposed a territorial (or exemption) system for active business income earned abroad through branches and foreign subsidiaries. *See* PRESIDENT’S ADVISORY PANEL ON FEDERAL TAX REFORM, SIMPLE, FAIR, AND PRO-GROWTH: PROPOSALS TO FIX AMERICA’S TAX SYSTEM 102–03 (2005); STAFF OF J. COMM. ON TAXATION, 109TH CONG., REPORT ON OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES 186–97 (Comm. Print 2005). *See generally* Lawrence Lokken, *Territorial Taxation: Why Some U.S. Multinationals May Be Less Than Enthusiastic About the Idea (and Some Ideas They Really Dislike)*, 59 SMU L. REV. 751 (2006).

140. *See* CRITERIA FOR APPLYING THE EQUITY METHOD OF ACCOUNTING FOR INVESTMENTS IN COMMON STOCK, FASB Interpretation No. 35, § 3 (Fin. Accounting Standards Bd. 1981); THE EQUITY METHOD OF ACCOUNTING FOR INVESTMENTS IN COMMON STOCK, APB Op. No. 18, § 17 (Accounting Principles Bd. 1971) [hereinafter THE EQUITY METHOD OF ACCOUNTING FOR INVESTMENTS IN COMMON STOCK].

141. THE EQUITY METHOD OF ACCOUNTING FOR INVESTMENTS IN COMMON STOCK, *supra* note 140, § 10.

parent corporation and the investee corporation is referred to as the subsidiary corporation.<sup>142</sup> The parent corporation will still account for its investment in the subsidiary corporation under the equity method.<sup>143</sup>

In addition, the U.S. parent will file consolidated financial statements, which generally means that the income of the foreign subsidiary will be consolidated with the income of the U.S. parent.<sup>144</sup> To compute the U.S. parent's book basis in its foreign subsidiary stock, the foreign subsidiary's income flows through to the U.S. parent under the equity method for financial accounting purposes.<sup>145</sup> As a result, for financial accounting purposes, the U.S. parent will increase its basis in the stock of the foreign subsidiary.<sup>146</sup> For tax purposes, however, the foreign subsidiary's income will not flow through to the U.S. parent (assuming one of the anti-deferral regimes is not applicable), and the U.S. parent's tax basis in its foreign subsidiary will remain unchanged. As a result, the U.S. parent's book basis in its foreign subsidiary will be greater than its tax basis by the amount of income flowing through to the U.S. parent. Generally, under the financial accounting rules, the excess of book basis over tax basis in an asset is a temporary difference leading to the recording of a deferred tax liability with a corresponding increase to deferred tax expense.<sup>147</sup>

Under the financial accounting rules, FASB has provided an exception to the recording of this deferred tax liability: if there is sufficient evidence that the foreign subsidiary has invested or will invest its undistributed

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142. See, e.g., CONSOLIDATION OF ALL MAJORITY-OWNED SUBSIDIARIES, Statement of Financial Accounting Standards No. 94, §§ 1–2, 13 (Fin. Accounting Standards Bd. 1987) [hereinafter CONSOLIDATION OF ALL MAJORITY-OWNED SUBSIDIARIES]. For tax purposes, only if the investor corporation owns 80% or more of the investee corporation is the investor corporation referred to as the parent corporation and the investee corporation as the subsidiary corporation. See I.R.C. §§ 332, 337, 1504 (2006).

143. See KIESO, ET AL., *supra* note 12, at 852.

144. See, e.g., ACCOUNTING FOR THE IMPAIRMENT OR DISPOSAL OF LONG-LIVED ASSETS, Statement of Financial Accounting Standards No. 144, § 2, B119 (Financial Accounting Standards Bd. 2001); CONSOLIDATION OF ALL MAJORITY-OWNED SUBSIDIARIES, *supra* note 142, § 9.

145. Under the equity method, the income will flow through the foreign subsidiary to its U.S. parent. See THE EQUITY METHOD OF ACCOUNTING FOR INVESTMENTS IN COMMON STOCK, *supra* note 140, § 10. In essence, the income of the foreign subsidiary is aggregated with the income of its U.S. parent. If the U.S. parent and foreign subsidiary file consolidated financial statements, the income of the foreign subsidiary is aggregated with the income of its U.S. parent. Both the equity method and consolidation, in essence, aggregate the income of the foreign subsidiary with its U.S. parent. As a result, the equity method is sometimes referred to as “one-line consolidation.” See EPSTEIN, ET AL., *supra* note 21, at 475.

146. THE EQUITY METHOD OF ACCOUNTING FOR INVESTMENTS IN COMMON STOCK, *supra* note 140, § 10 (“An investor adjusts the carrying amount of an investment for its share of the earnings or losses of the investee subsequent to the date of investment . . .”).

147. ACCOUNTING FOR INCOME TAXES, *supra* note 32, §§ 32–33, 289 (recognizing that book basis over tax basis in an asset is a taxable temporary difference).

earnings indefinitely.<sup>148</sup> This exception to the recording of a deferred tax liability is referred to as the APB 23 provision, named after Opinion No. 23 issued by the Accounting Principles Board (APB) in 1972.<sup>149</sup>

To illustrate the financial accounting advantage of APB 23, assume U.S. parent owns 100% of the stock of a foreign subsidiary. U.S. parent's basis in foreign subsidiary is \$1 million for book and tax purposes. U.S. parent has pretax financial income of \$40 million in 2007, and foreign subsidiary has pretax financial income of \$20 million in 2007. Assume U.S. parent is subject to a 35% U.S. tax rate and foreign subsidiary is located and operating in a no-tax jurisdiction. Under the equity method, U.S. parent will include foreign subsidiary's pretax financial income in its income, thereby increasing U.S. parent's pretax financial income to \$60 million for 2007. If the U.S. parent was required to record a deferred tax liability for the excess of its book basis over its tax basis in the stock in its foreign subsidiary, then the U.S. parent would record a \$7 million deferred tax liability and deferred tax expense of \$7 million. This would reduce the U.S. parent's net income from \$46 million to \$39 million (\$40 million of income less \$14 million in taxes plus \$20 million income from foreign subsidiary). In business terms, the U.S. parent takes a charge to earnings of \$7 million as a result of recording the deferred tax liability.

If the U.S. parent can show that the foreign subsidiary has invested or will invest the undistributed earnings indefinitely, then the U.S. parent may utilize APB 23 to avoid recording a \$7 million deferred tax liability and therefore avoid a \$7 million increase to deferred tax expense (i.e., U.S. parent avoids a charge to earnings). As a result, the U.S. parent's net income will remain at \$46 million. The following table shows U.S. parent's net income if it utilizes APB 23 and compares it to the U.S. parent's net income if it is unable to utilize APB 23:

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148. *Id.* §§ 31(a), 288(f); ACCOUNTING FOR INCOME TAXES, APB Op. No. 23, § 12 (Accounting Principles Bd. 1972) [hereinafter APB Op. No. 23] ("The presumption that all undistributed earnings will be transferred to the parent company may be overcome, and no income taxes should be accrued by the parent company, if sufficient evidence shows that the subsidiary has invested or will invest the undistributed earnings indefinitely or that the earnings will be remitted in a tax-free liquidation.").

149. APB Op. No. 23, *supra* note 148, § 12.



	Consolidated Income Statement (APB 23 Used)	Consolidated Income Statement (APB 23 Not Used)
Revenues:	\$60,000,000	\$60,000,000
Expenses:	\$0	\$0
Pretax Financial Income	\$60,000,000	\$60,000,000
Current Tax Expense	\$14,000,000	\$14,000,000
Deferred Tax Expense	\$0	\$7,000,000
Net Income	\$46,000,000	\$39,000,000

By utilizing APB 23, the U.S. parent's net income is \$7 million higher than it would be in the absence of APB 23. This will lead to a higher EPS. In addition, using APB 23 lowers the U.S. parent's effective tax rate. In the example, the effective tax rate utilizing APB 23 is equal to 23.33% (\$14 million (income tax expense) divided by \$60 million (operating income)).<sup>150</sup> The effective tax rate if APB 23 is not applicable is equal to 35% (\$21 million (income tax expense) divided by \$60 million (operating income)). In essence, APB 23 converts a temporary difference into a permanent difference. The permanent difference in turn increases the U.S. parent's net income, increases its EPS, and decreases its effective tax rate. As a result, Corporate America greatly values APB 23.

Tax scholars have discussed the benefits of tax deferral of foreign subsidiaries' income. But just as important is the financial accounting rules' treatment of the foreign subsidiary's income as a permanent difference. If FASB were to repeal APB 23, thereby requiring the U.S. parent to record a deferred tax liability for the excess of its book basis over its tax basis in the stock of the foreign subsidiary, the U.S. parent could possibly place much less value on the tax deferral benefit of delaying repatriation of foreign subsidiaries' income.<sup>151</sup> The U.S. parent would have already taken a charge to earnings for the U.S. tax on the foreign subsidiary's income prior to repatriation if APB 23 were repealed. It is possible the U.S. parent would then simply repatriate the earnings of the

150. In the example, operating income is assumed to equal pretax financial income.

151. If FASB were to repeal APB 23, a number of practical problems may arise in calculating the deferred tax liability (and deferred tax asset) for the excess of the U.S. parent's book basis over its tax basis in the stock of the foreign subsidiary. FASB noted that the "hypothetical nature of [the] calculations introduces significant implementation issues and other complexities that occur less frequently in calculations of a deferred tax liability for an *expected* remittance of earnings from a foreign entity." ACCOUNTING FOR INCOME TAXES, *supra* note 32, § 173. In addition, the U.S. parent would have to calculate the foreign tax credit consequences of a hypothetical remittance of earnings from a foreign subsidiary, which would involve currency exchange rates, in determining the recording of a deferred tax asset. *See id.* § 174.

foreign subsidiary since there is no need to keep the income offshore because it has already taken a charge on the income statement for the U.S. taxes that would be owed on repatriation.<sup>152</sup>

When the Accounting Principles Board enacted APB 23 in April 1972, several members of the Board dissented to the omission of a requirement providing for deferred income taxes.<sup>153</sup> The dissenting members believed that the earnings of the foreign subsidiary were being accounted for under the accrual method while the related income taxes were being accounted for under the cash method.<sup>154</sup> They viewed this arrangement as completely contrary to the concept of deferred tax accounting for other businesses.<sup>155</sup> In addition, the dissenting members believed that the accounting distinction between over 50% investors (no deferred income taxes) and 50%-or-less investors (accounting for deferred income taxes) was completely artificial.<sup>156</sup>

FASB revisited APB 23 with the enactment of FAS 109 in 1992. FASB changed many parts of APB 23, but retained an exception for the

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152. As part of the American Jobs Creation Act of 2004, Congress enacted a temporary provision permitting U.S. corporations to repatriate the earnings of their foreign subsidiaries with an 85% dividends received deduction. I.R.C. § 965(a)(1) (2006). U.S. corporations repatriated billions of earnings of foreign subsidiaries utilizing the temporary 85% dividends received deduction. See Melissa Redmiles, *The One-Time Received Dividend Deduction*, 27 SOIBULL. 102, 103 (2008) (stating that approximately 840 mostly large corporations repatriated nearly \$362 billion from their controlled foreign corporations (CFCs) and deducted about \$265 billion of these dividends from their taxable incomes between Tax Years 2004 and 2006 due to the one-time dividend received deduction enacted in the American Jobs Creation Act of 2004). It is hard to know whether the repatriation was due to the lower U.S. income taxes owed on the repatriated earnings, the lower charge to earnings on the income statement as a result of the lower taxes, or a combination of the two.

To illustrate, using a planning technique under APB 23, consider the following example, for which I thank Dan Leightman. Assume a U.S. target corporation with a foreign subsidiary is acquired by merger by another U.S. corporation. U.S. target corporation has utilized APB 23 with respect to its foreign subsidiary (which has \$100 of income) to avoid recognizing a \$35 deferred tax liability and therefore a \$35 deferred tax expense. After U.S. acquiring corporation agrees to acquire U.S. target corporation but prior to the actual acquisition, U.S. target corporation no longer utilizes APB 23 and, as a result, recognizes a deferred tax liability of \$35 with a corresponding increase to deferred tax expense of \$35. The increase to deferred tax expense of \$35 will lower the U.S. target corporation's net income but is of little consequence because the U.S. target corporation has already agreed to be acquired by U.S. acquiring corporation. See HANNA, *supra* note 27, ch.4. (Possibly, investors in the acquiring corporation may be concerned about the U.S. target corporation's lower net income as a result of no longer using APB 23.) After the acquisition, the U.S. acquiring corporation can repatriate the \$100 of income of its newly acquired foreign subsidiary without affecting its income statement (i.e., no further charge to earnings). It will, of course, pay taxes on the \$100 of repatriated funds but will not take a charge to earnings.

153. APB Op. No. 23, *supra* note 148, § 33.

154. *Id.*

155. *Id.*

156. *Id.*

recognition of a deferred tax liability with respect to a more than 50% investment in a foreign corporation (i.e., a foreign subsidiary as defined for financial accounting purposes).<sup>157</sup> As a result, while accelerated depreciation, installment method, and income of foreign corporations all involve tax deferral, only one of them is of critical importance to Corporate America—income of foreign corporations. The reason is not directly related to the tax laws. Rather, it is the financial accounting rules that make income of foreign corporations of critical importance. Corporate America aggressively seeks out permanent differences. APB 23 creates a permanent difference for Corporate America with respect to foreign subsidiaries' income. In contrast, a corporation's use of accelerated depreciation or the installment method creates only temporary differences.

## V. REFLECTIONS ON PERMANENT AND TEMPORARY DIFFERENCES

### A. *General Principles*

Corporate America highly covets permanent differences, which may increase a corporation's net income and EPS, and decrease a corporation's effective tax rate. In contrast, temporary differences do not increase a corporation's net income, do not increase a corporation's EPS, and do not lower a corporation's effective tax rate. As a result, Corporate America does not covet temporary differences nearly as much as it does permanent differences.

### B. *Advantages of Temporary Differences*

While Corporate America prizes permanent differences much more than temporary differences, temporary differences are still relevant. A temporary difference may increase a company's cash flow.<sup>158</sup> The statement that "[h]appiness is a positive cash flow" is certainly true.<sup>159</sup> For small and new companies, cash flow is considered the single most important element for survival.<sup>160</sup> For publicly traded companies, corporate management focuses on the income statement while also controlling the

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157. ACCOUNTING FOR INCOME TAXES, *supra* note 32, § 31(a). FASB retained an exception for the recognition of a deferred tax liability with respect to a more than 50% investment in a foreign corporation "because of (a) the complexity of measuring the deferred tax liability for foreign undistributed earnings, (b) the need to compromise, and (c) the omission of discounting." *Id.* § 169.

158. In 1970, the SEC required that companies registered with the SEC include a funds flow statement, which is the predecessor to the cash flow statement, in their annual SEC filings. See LANNY G. CHASTEEN, ET AL., INTERMEDIATE ACCOUNTING 1063–64 (2d ed. 1987).

159. See KIESO, ET AL., *supra* note 12, at 195.

160. *Id.*

company's cash flow. Investors also focus on the income statement but may look at a company's cash flow in assessing the company's liquidity, financial flexibility, and overall performance.<sup>161</sup>

Increasing cash flow may help a company in several ways. Famed investor Warren Buffet, the chairman of Berkshire Hathaway, Inc., has noted the time value of money benefits of temporary differences (which create deferred tax liabilities):

Besides, Berkshire has access to two low-cost, non-perilous sources of leverage that allow us to safely own far more assets than our equity capital alone would permit: deferred taxes and "float," the funds of others that our insurance business holds because it receives premiums before needing to pay out losses. Both of these funding sources have grown rapidly and now total about \$69 billion.

Better yet, this funding to date has often been cost-free. Deferred tax liabilities bear no interest. And as long as we can break even in our insurance underwriting the cost of the float developed from that operation is zero. Neither item, of course, is equity; these are real liabilities. But they are liabilities without covenants or due dates attached to them. In effect, they give us the benefit of debt—an ability to have more assets working for us—but saddle us with none of its drawbacks.<sup>162</sup>

Another way that increasing cash flow can help is by paying down debt. Debt reduction has several advantages. For instance, many companies believe that "removing debt enhances the quality of the balance sheet" and thereby permits obtaining credit more readily at a lower cost.<sup>163</sup> In addition, loan covenants typically limit the amount of debt a company may have.<sup>164</sup> Deferred tax liabilities are not typically treated as debt for this purpose thereby giving, as Buffet noted, some of the advantages of debt without the drawbacks. Finally, debt reduction decreases the "debt to total assets ratio." The ratio is calculated as total debt (both current and long-term liabilities) divided by total assets.<sup>165</sup> The higher a corporation's debt-to-assets ratio, the greater the risk that the corporation may be unable to meet its obligations as they mature.<sup>166</sup>

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161. *Id.* at 191.

162. BERKSHIRE HATHAWAY, INC., 2006 ANNUAL REPORT 75–76 (2007), available at <http://www.berkshirehathaway.com/2006ar/2006ar.pdf>.

163. See KIESO, ET AL., *supra* note 12, at 692.

164. *Id.*

165. *Id.* at 695.

166. *Id.*

A reduction in interest expense also has several advantages. First, it increases net income for the year, which, in itself, is a valuable benefit for the company. Moreover, because interest expense is accounted for above the income tax expense line on the income statement, it increases pretax financial income for the year, which is an even greater benefit for a company than simply increasing net income.<sup>167</sup> Second, a reduction in interest expense also increases the “times interest earned ratio.” This ratio is determined by dividing the sum of pretax financial income and interest expense by interest expense.<sup>168</sup> The higher a corporation’s times interest earned ratio is, the greater the probability that the corporation can meet its interest payments as they come due.<sup>169</sup> The times interest earned ratio is an important ratio to long-term creditors and stockholders in determining the long-run solvency of the corporation.<sup>170</sup>

**Example 10.** In its 2005 Annual Report, Best Buy reported total liabilities of \$5.845 billion, total assets of \$10.294 billion, interest expense of \$44 million, income tax expense of \$509 million, and net income of \$984 million.<sup>171</sup> Best Buy’s debt-to-asset ratio is \$5.845 billion divided by \$10.294 billion equaling 56.8%. This is considered a relatively high debt-to-asset ratio.<sup>172</sup> Best Buy’s times interest earned ratio is \$1.537 billion (\$984 million of net income plus \$44 million of interest expense plus \$509 million of income tax expense) divided by \$44 million equaling 35 times. Best Buy’s interest coverage of 35 times indicates that it can easily meet its interest payments when they come due.<sup>173</sup>

Rather than paying down debt, a company may use an increase in cash in its business operations to increase its pretax financial income (and therefore net income) in future years.<sup>174</sup> Increasing its pretax financial income will also increase the company’s EPS. As a result, temporary

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167. The reduction in interest expense should increase pretax financial income by a greater amount than the increase in net income because of the dilution by income tax expense. For example, using a 35% tax rate, a reduction in interest expense of \$100 will increase pretax financial income by \$100 but will only increase net income by \$65.

168. See KIESO, ET AL., *supra* note 12, at 695.

169. See *id.* at 695–96.

170. *Id.*

171. BEST BUY, FISCAL 2005 ANNUAL REPORT 58–59, 80 (2006), available at [http://media.corporate-ir.net/media\\_files/IROL/83/83192/reports/BestBuyAR05.pdf](http://media.corporate-ir.net/media_files/IROL/83/83192/reports/BestBuyAR05.pdf).

172. See KIESO, ET AL., *supra* note 12, at 696.

173. *Id.*

174. Generally, a company will utilize an increase in cash in its business operations if it can earn at least the weighted average cost of capital.

differences may not have an immediate impact on net income or EPS but may have a future impact by paying down debt or increasing income from business or investment operations.<sup>175</sup>

Because of the importance of the income statement to corporate management, if a permanent difference and a temporary difference both create an equal net present value of future cash flows, corporate management will favor the permanent difference over the temporary difference because of its positive impact on net income, EPS, and effective tax rate.<sup>176</sup> In fact, corporate management may even sacrifice net present value of future cash flows in exchange for a net income and EPS benefit.

### *C. Why Temporary Differences are Unimportant To Corporate America*

If there are advantages to temporary differences, why are companies so focused on permanent differences and almost indifferent to temporary differences?<sup>177</sup> There may be several reasons for this preference. First, as demonstrated, temporary differences do not provide an immediate impact on the income statement. In other words, they do not increase net income for the period in which the temporary difference arises, and therefore do not immediately increase EPS. They also do not have an immediate impact on the company's effective tax rate. Rather, a temporary difference creates a deferred tax liability on the company's balance sheet. This means that the company defers paying some taxes; however, the deferred taxes are treated as deferred tax expense for the year that the temporary difference arises. As a result, the income statement reflects in full the taxes that will

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175. The cash flow and balance sheet benefits of temporary differences may be valuable to a corporation that is the target of a takeover or a corporation that is putting itself up for sale.

176. Cf. STAFF OF J. COMM. ON TAXATION, 109TH CONG., PRESENT LAW AND BACKGROUND RELATING TO CORPORATE TAX REFORM: ISSUES OF CONFORMING BOOK AND TAX INCOME AND CAPITAL COST RECOVERY, 20–33 (Comm. Print 2006) (noting how the investment tax credit, in contrast to expensing or accelerated depreciation, lowers a corporation's effective tax rate but then focuses on net present value of cash flows in determining what is desirable to taxpayers).

177. Some items that lead to differences between pretax financial income and taxable income are, in a sense, permanent differences but are treated as temporary differences under the financial accounting rules. For example, assume a corporation acquires a depreciable asset with a book basis of zero and a tax basis of \$100,000. The corporation will depreciate the asset upon acquisition. For financial accounting purposes, the corporation will have no depreciation expense because its initial book basis is zero. For tax purposes, however, the corporation will, over the asset's applicable recovery period, have \$100,000 of depreciation deductions. As a result, taxable income over the asset's applicable recovery period will be \$100,000 less than its financial income over the same time period. This difference is permanent—it will not reverse over time. See, e.g., App. J to Second Interim Report of Neal Batson, Court Appointed Examiner at 5–6, *In re Enron Corp.*, No. 01-16034 (AJG) (Bankr. S.D.N.Y. Jan. 21, 2003).

be paid in the future. In other words, the company takes a current charge to earnings for the deferred taxes even though the taxes may not be paid for many years.<sup>178</sup>

A company is not permitted to discount deferred taxes even if the timing of paying the deferred taxes is known with some or even exact precision.<sup>179</sup> For example, assume a company makes an installment sale of property in 2007 in which the gain is \$1 million and the sales price will be paid in its entirety in 2010. Using a 35% corporate tax rate, the company will record a deferred tax liability of \$350,000 and a deferred tax expense of \$350,000 in 2007. The company is not permitted to discount the \$350,000 deferred tax liability (and deferred tax expense) to its present value. If doing so were permitted, then the deferral of the \$350,000 of tax would provide an immediate benefit on the income statement equal to the excess of \$350,000 over the present value of \$350,000 (discounted three years).

The APB, which was the predecessor to FASB, addressed the issue of discounting deferred taxes.<sup>180</sup> The APB wrote that it was “giving attention” to the issue of whether certain long-term deferred taxes should be discounted as recommended in an Accounting Research Study.<sup>181</sup> The APB concluded that “[p]ending further consideration of this subject and the broader aspects of discounting as it is related to financial accounting in general . . . deferred taxes should not be accounted for on a discounted basis.”<sup>182</sup> If deferred taxes were discounted, then it would provide an immediate benefit on the income statement. But, because discounting is prohibited, temporary differences provide no immediate income statement benefit.<sup>183</sup>

178. It is not uncommon for a chief financial officer to ask the tax advisor, “Has the item in question already hit the income statement?” What this generally means is whether the corporation has fully accounted for the deferred tax consequences of the item. If so, then no current or future income statement benefit will result from the item (except for an increase in cash flow that may lead to a future income statement benefit).

179. See OMNIBUS OPINION, *supra* note 127, § 6.

180. *Id.*

181. *Id.*; see also HOMER A. BLACK, INTERPERIOD ALLOCATION OF CORPORATE INCOME TAXES: ACCOUNTING RESEARCH STUDY NO. 9 29 (1966).

182. OMNIBUS OPINION, *supra* note 127, § 6.

183. In some cases, deferred taxes may, in essence, be discounted. If the base amount, for which deferred taxes are calculated, is a discounted amount, then the deferred taxes are also, in a sense, discounted. See OMNIBUS OPINION, *supra* note 127, § 6 (“Messrs. Davidson and Weston do not agree with the conclusion of the Board that further use of the discounting (or present value) technique in measuring the current cost of deferred income taxes is not acceptable, pending further consideration of this subject by the Board. They point out that Accounting Research Study No. 9 concluded that this method is required whenever the interest factor is significant. They recognize that the Board is attempting to prevent the development of an alternative practice until it has had an opportunity to consider the subject matter thoroughly and form an opinion thereon. On the other

Because deferred taxes are not discounted, coupled with the possibility that corporate management is focused on the current period rather than looking ahead to future periods, temporary differences simply may not be that important. Temporary differences may provide an immediate impact on the cash flow statement but, unless the company is in a cash flow crisis, this statement is generally considered less important to corporate management and investors than the income statement.

A second reason why companies may not prize temporary differences is that the deferral period relating to the temporary difference could be quite short. In other words, not all temporary differences are created equal. Some temporary differences may not reverse for many years, thereby creating a much larger benefit to the company than a temporary difference that reverses, for example, in one or two years.

In some cases, however, temporary differences that reverse in a relatively short time period may actually create a deferral period of an indefinite nature. For example, if a company purchases equipment and uses accelerated depreciation for tax purposes and straight-line depreciation for financial accounting purposes, it will recognize a deferred tax liability in depreciating the equipment. The amount of the deferred tax liability will start to decrease as the financial accounting depreciation begins to exceed the tax depreciation for the year, which may occur in just a few years. If, however, the company continues to purchase equipment, a new deferred tax liability will be created with respect to the new equipment that can be viewed as, in essence, replacing the old deferred tax liability. When viewed in the aggregate, the total deferred tax liability may not change very much from year to year. As a result, the company is achieving an indefinite deferral of taxes.<sup>184</sup>

Another reason a number of companies may not value temporary differences is that many companies have paid no corporate income taxes to the U.S. government despite showing net income on the income statement and a positive effective tax rate in the tax footnote to the

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hand, the Board has required use of the discounting technique in measuring the present value of obligations due in the future in (a) the capitalization of leases (Opinion No. 5—paragraph 15) and (b) the accrual of pension costs (Opinion No. 8—paragraphs 23 and 42). They find it difficult to reconcile these inconsistent positions of the Board on similar questions of measurement.”).

184. FASB has recognized the indefinite deferral aspect of deferred tax liabilities with respect to items such as depreciation on equipment. See ACCOUNTING FOR INCOME TAXES, *supra* note 32, §§ 203–205. In deciding what approach to adopt with respect to deferred taxes, FASB considered what is known as the “partial recognition of deferred taxes.” *Id.* Under this approach, a deferred tax liability is not recognized if the cumulative amount of temporary differences for a particular recurring item, such as depreciation, does not reverse in future years because new originating differences offset reversing differences. *Id.* FASB rejected such an approach noting that “the deferred tax consequences of a depreciation difference for a particular depreciable asset ordinarily will result in a sacrifice [reverse resulting in taxes owed] in future years.” *Id.* § 205.



financial statements. Apparently, this posture was prevalent in the late 1990s and early 2000s.<sup>185</sup> If a company pays no federal income taxes to the U.S. government, then temporary differences confer little to no benefit; however, permanent differences can still create a significant benefit. To illustrate, assume a corporation has net income of \$500 million and has no tax liability to the U.S. government. In addition, the corporation has \$10 million of permanent differences increasing the corporation's net income to \$510 million. The permanent differences will increase the corporation's EPS. They may also lower the corporation's effective tax rate. As a result, the permanent differences are still beneficial to the corporation even though it has no U.S. tax liability for the year. In contrast, temporary differences would not benefit the corporation because it is not paying any taxes to the U.S. government, so no taxes are saved in the current year as a result of the deferral.<sup>186</sup>

It is important to distinguish the taxes that a company pays to the U.S. government from its effective tax rate. For example, Enron paid no federal income taxes in the years 1996 to 1999, yet reported in those years effective tax rates of 31.7%, (598.3)%, 20.0%, and 9.2%, respectively, in its financial statements.<sup>187</sup> In addition, Enron reported consolidated net

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185. See, e.g., U.S. GEN. ACCOUNTING OFFICE, REP. NO. GAO-08-957, TAX ADMINISTRATION: COMPARISON OF THE REPORTED TAX LIABILITIES OF FOREIGN- AND U.S.-CONTROLLED CORPORATIONS, 1998–2005 8 (2008) (discovering that between 1998 and 2005 55% of U.S. controlled corporations reported no tax liability for at least one year during those eight years, 42% of those corporations reported no tax liability in multiple years, and 24% of those corporations reported no tax liability for at least half the study period); U.S. GEN. ACCOUNTING OFFICE, REP. NO. GAO-04-358, TAX ADMINISTRATION: COMPARISON OF THE REPORTED TAX LIABILITIES OF FOREIGN- AND U.S.-CONTROLLED CORPORATIONS, 1996–2000 16–18 (2004) (finding that from 1996 to 2000, a large percentage of U.S. controlled corporations with either assets of at least \$250 million or gross receipts of at least \$50 million had no tax liability; the percentages with no tax liability were 32.7% in 1996, 35.5% in 1997, 37.8% in 1998, 40.9% in 1999, and 45.3% in 2000); ROBERT S. MCINTYRE & T.D. COO NGUYEN, CORPORATE INCOME TAXES IN THE BUSH YEARS 3 (2004), available at <http://www.ctj.org/corpfed04an.pdf> (concluding that 82 of the 275 largest U.S. corporations paid no income taxes in at least one year from 2001 to 2003).

186. The temporary differences may create, increase, or preserve a net operating loss of the corporation that can be carried back two years and carried forward twenty years. I.R.C. § 172 (2006). Increasing a net operating loss carryforward is generally considered to be a minor benefit to a corporation.

187. See ENRON CORP., ANNUAL REPORT 1999 50 (2000), available at <http://picker.uchicago.edu/Enron/EnronAnnualReport1999.pdf> (listing Enron's net income and effective tax rates for 1997, 1998 and 1999) [hereinafter ENRON CORP., ANNUAL REPORT 1999]; ENRON CORP., ANNUAL REPORT 1998 55 (1999), available at <http://picker.uchicago.edu/Enron/EnronAnnualReport1998.pdf> [hereinafter ENRON CORP., ANNUAL REPORT 1998] (listing Enron's net income and effective tax rates for 1996, 1997 and 1998); see also STAFF OF J. COMM. ON TAXATION, 108TH CONG., 1 REPORT OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES, AND POLICY RECOMMENDATIONS, 5 tbl. 1 (Comm. Print 2003) [hereinafter INVESTIGATION OF ENRON REPORT] (showing Enron's

income of \$584 million, \$105 million, \$703 million, and \$893 million, respectively, in its financial statements for the years 1996 to 1999.<sup>188</sup> So even though Enron reported significant amounts of net income for the period 1996 to 1999, and reported positive effective tax rates in three out of four years from 1996 to 1999, it paid no federal income taxes during that period.<sup>189</sup>

Several reasons explain why a corporation may show net income and a positive effective tax rate in its financial statements, yet pay no taxes to the U.S. government. It may, for example, have a net operating loss that it is carrying forward, eliminating its U.S. tax liability.<sup>190</sup> In Enron's case,

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federal tax liability from its federal income tax returns).

188. See ENRON CORP., ANNUAL REPORT 1999, *supra* note 187, at 41; ENRON CORP., ANNUAL REPORT 1998, *supra* note 187, at 45; see also INVESTIGATION OF ENRON REPORT, *supra* note 187, at 7.

189. Enron used temporary differences that were, in essence, permanent differences in a number of (now) well-publicized transactions. App. J to Second Interim Report of Neal Batson, Court Appointed Examiner at 5, *In re Enron Corp.*, No. 01-16034 (AJG) (Bankr. S.D.N.Y. Jan. 21, 2003). From 1996 to 1999, Enron had no need for temporary differences because it was not paying any taxes to the U.S. government. See INVESTIGATION OF ENRON REPORT, *supra* note 187, at 5 & tbl.1. Enron could, however, use permanent differences to increase its net income, increase its EPS, and lower its effective tax rate. App. J to Second Interim Report of Neal Batson, Court Appointed Examiner at 46, *In re Enron Corp.*, No. 01-16034 (AJG) (Bankr. S.D.N.Y. Jan. 21, 2003).

Enron Corporation used the recording of deferred tax assets to increase its net income each year. See *id.* Enron, which at one time was the seventh largest U.S. corporation according to *Fortune* magazine, see *FORTUNE500 A Database of 50 Years of FORTUNE's List of America's Largest Corporations, 1955–2005*, [http://money.cnn.com/magazines/fortune/fortune500\\_archive/full/2001/](http://money.cnn.com/magazines/fortune/fortune500_archive/full/2001/) (last visited Feb. 20, 2009), planned a number of tax-motivated transactions from 1995 to 2001. App. J to Second Interim Report of Neal Batson, Court Appointed Examiner at 1, *In re Enron Corp.*, No. 01-16034 (AJG) (Bankr. S.D.N.Y. Jan. 21, 2003). Two of Enron's tax-motivated transactions can be characterized as "REMIC Carryover Basis Transactions." *Id.* at 2. Three of its tax-motivated transactions can be characterized as "Tax-Basis Step-Up Transactions." *Id.* at 45.

The REMIC Carryover Basis Transactions involved Enron acquiring REMIC residual interests. *Id.* at 2. These interests would generate a substantial amount of tax losses in future years. *Id.* Enron's tax basis in the REMIC residual interests greatly exceeded its book basis in the interests, thereby permitting Enron to record a deferred tax asset for the difference. *Id.* at 37. Enron also recorded a balancing deferred credit equal to the amount of the deferred tax asset. *Id.* at 37–38. As a general rule, a deferred credit is taken into income (generally as an offset to income tax expense) over time "using a rational and systematic basis." *Id.* at 38. However, Enron acquired other assets (such as corporate bonds) along with the REMIC residual interests. *Id.* By doing so, it amortized the deferred credit into income over the life of the bonds. *Id.* Enron reported the amortization of the deferred credit as "Other Revenue" on its financial statements. *Id.* at 39.

The Tax Basis Step-Up Transactions involved Enron acquiring depreciable assets in some future year. *Id.* at 5. Enron's tax bases in the depreciable assets when it eventually acquired them would be substantially greater than its book bases in the assets. See *id.* at 6. Enron recorded a deferred tax asset for the expected excess of the tax bases over the book bases in the depreciable assets with a corresponding decrease to deferred tax expense. *Id.*

190. A corporation may also have a large amount of excess tax credits that it is carrying forward—reducing its tax liability to the U.S. government in future years.

it had a large net operating loss that it carried forward each year, eliminating its tax liability each year.<sup>191</sup> A net operating loss does not reduce net income and it does not appear in the effective tax reconciliation.<sup>192</sup> As a result, a corporation may continue to show net income and a positive effective tax rate while having its entire taxable income offset by a net operating loss carryforward.

Another reason why a company may show net income and a positive effective tax rate in its financial statements and pay no taxes to the U.S. government may be due, in large part, to the exercise of nonqualified stock options.<sup>193</sup> When an employee exercises a nonqualified stock option, the difference between the fair market value of the stock acquired as a result of the exercised option and the exercise price (i.e., the spread), is compensation income to the employee.<sup>194</sup> The corporation is entitled to a deduction in the same amount and in the same taxable year as the employee's compensation income.<sup>195</sup>

For financial accounting purposes, the corporation may record an expense upon issuing the stock option.<sup>196</sup> If the corporation records an expense upon issuance, it will also record a deferred tax asset with an offset to deferred tax expense.<sup>197</sup> When the employee exercises the stock option in a later year, the corporation does not record any further expense. In addition, the compensation deduction's tax benefit is not reflected on

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191. See ENRON CORP., ANNUAL REPORT 1999, *supra* note 187, at 51; ENRON CORP., ANNUAL REPORT 1998, *supra* note 187, at 55; see also INVESTIGATION OF ENRON REPORT, *supra* note 187, at 5–6.

192. A corporation with a net operating loss carryforward creates a deferred tax asset on the corporation's balance sheet. ACCOUNTING FOR INCOME TAXES, *supra* note 32, §§ 16, 17(c). The deferred tax asset may be subject to a valuation allowance. *Id.* §§ 17(e), 20–25. If a corporation records a valuation allowance with respect to its net operating loss carry forward, then that means that the corporation has determined that it may not utilize a portion of its carry forward due to a lack of taxable income in the future. The valuation allowance would affect the corporation's effective tax rate.

193. See, e.g., Martin A. Sullivan, *Corporate Tax Revenues: Up, Down, and All Around*, 95 TAX NOTES 25, 27 (2002) (suggesting stock options, research credit, and corporate tax shelters may be the reasons for the decline in corporate tax revenues); Martin A. Sullivan, *Stock Options Take \$50 Billion Bite Out of Corporate Taxes*, 94 TAX NOTES 1396, 1396–97 (2002); George K. Yin, *How Much Tax Do Large Public Corporations Pay?: Estimating the Effective Tax Rates of the S&P 500*, 89 VA. L. REV. 1793, 1796 (2003); Stephen Joyce, *Senate Hearing May Discuss Legislation About Stock Option Book, Tax Differences*, BNA DAILY TAX REPORT, June 4, 2007, at G-3 (stating that based on Schedules M-3 submitted between December 31, 2004, and June 30, 2005, a \$43 billion gap existed between stock option expenses for financial accounting purposes and stock option deductions for tax purposes).

194. I.R.C. § 83(a) (2006).

195. *Id.* § 83(h).

196. See SHARE-BASED PAYMENT, *supra* note 63, § 1 (establishing fair value method in determining total compensation cost).

197. See *id.* §§ 59–61.

the income statement but rather is recorded to additional paid-in capital.<sup>198</sup> As a result, the corporation's effective tax rate is unaffected by the exercise of the stock options even though the corporation's taxes paid to the U.S. government may have been significantly reduced.

**Example 11.** ABC Corporation issues nonqualified stock options in 2002. The corporation records stock option expense of \$10 million on its income statement for each of the years 2002, 2003, and 2004.<sup>199</sup> Using a 35% corporate tax rate, the corporation will also record a deferred tax asset of \$3.5 million with a decrease to income (deferred) tax expense of \$3.5 million in each of the three years. As a result, the impact on the income statement in each year will be a reduction of net income by \$6.5 million (\$10 million expense less decrease to income (deferred) tax expense of \$3.5 million). In 2007, the employees exercise the stock options resulting in a tax deduction of \$100 million, and therefore a tax savings of \$35 million. For financial accounting purposes, the deferred tax asset is reduced to zero, resulting in deferred tax expense of \$10.5 million (with a corresponding decrease of current tax expense). The excess of the \$100 million tax deduction over the \$30 million aggregate option expense creates a permanent difference between taxable income and pretax financial income of \$70 million. The tax effect of this permanent difference is \$24.5 million (\$70 million times 35%). This tax effect is not reflected in either the income statement or the effective tax reconciliation but rather is credited to additional paid-in capital.

In addition, a corporation may show net income for financial accounting purposes and no taxable income through the use of tax-motivated transactions, which may employ permanent differences, temporary differences, or a combination of the two.<sup>200</sup> These tax-motivated

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198. *See id.* § 62.

199. *See id.* §§ 39–49 (recognizing the requisite service period (i.e., vesting period) of the stock options).

200. Much has been written on the disparity in recent years between book income (i.e., net income for financial accounting purposes) and taxable income. *See, e.g., Compliance Concerns Relative to Large and Mid-Size Businesses: Hearing Before Sen. Comm. on Finance*, 109th Cong. (2006) (written testimony of Mark Everson, Comm'r); Mihir Desai, *The Divergence Between Book and Tax Income*, in 17 *TAX POLICY AND THE ECONOMY* 169, 169 (James M. Poterba ed., 2003); Michelle Hanlon, et al., *Evidence for the Possible Information Loss of Conforming Book Income and Taxable Income*, 48 *J.L. & ECON.* 407, 407–08 (2005); Hanlon, *supra* note 16, at 832–33; Manzoni & Plesko, *supra* note 16, at 192–94; Alison Bennett, *2004 Figures Show Big Discrepancy Between, Book, Tax Profits Among Firms*, *BNA DAILY TAX REPORT*, Nov. 28, 2006, at G-8 (observing that in 2004, publicly-traded companies reported \$554 billion in book income and only

transactions, sometimes referred to as corporate tax shelters, seemed to reach their zenith in the late 1990s and early 2000s—about the same time reports surfaced showing that many corporations paid no taxes to the U.S. government.<sup>201</sup>

Finally, some corporations' tax departments may best be described as "compliance shops." In such corporations, corporate management may not place much emphasis on tax planning, and, as a result, may not place much value, if any, on the benefits of temporary differences.<sup>202</sup> This may be particularly true with regard to corporations that have large net operating loss carryforwards or a significant amount of excess tax credits.

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\$394 billion in taxable income; companies may have reduced their taxable income by about \$35 billion through "potentially abusive transactions"); Lillian Mills & George Plesko, *Bridging the Reporting Gap: A Proposal for More Informative Reconciling of Book and Tax Income* 1–2 (Mass. Inst. of Tech. Sloan Sch. of Mgmt., Working Paper No. 4289-03, 2003).

For a discussion of corporate tax shelters, see generally STAFF OF J. COMM. ON TAXATION, 106TH CONG. 1 STUDY OF PRESENT-LAW PENALTY AND INTEREST PROVISIONS AS REQUIRED BY SECTION 3801 OF THE INTERNAL REVENUE SERVICE RESTRUCTURING AND REFORM ACT OF 1998 (INCLUDING PROVISIONS RELATING TO CORPORATE TAX SHELTERS) (Comm. Print 1999); U.S. DEP'T OF THE TREASURY, THE PROBLEM OF CORPORATE TAX SHELTERS: DISCUSSION, ANALYSIS, AND LEGISLATIVE PROPOSALS (1999); Mark P. Gergen, *The Logic of Deterrence: Corporate Tax Shelters*, 55 TAX L. REV. 255 (2002); Christopher H. Hanna, *Business Purpose, Economic Substance, and Corporate Tax Shelters*, 54 SMU L. REV. 3 (2001); Michael L. Schler, *Ten More Truths About Tax Shelters: The Problem, Possible Solutions, and a Reply to Professor Weisbach*, 55 TAX L. REV. 325 (2002).

The Treasury had promulgated regulations in which significant book-tax differences were required to be disclosed in certain cases. 26 C.F.R. § 1.6011-4(b)(6) (2006) (now removed) (significant book-tax difference is a transaction in which the amount for tax purposes of any item of income, gain, expense or loss differs by more than \$10 million on a gross basis from the amount of the item for book purposes; the disclosure requirement applies to reporting companies under the Securities Exchange Act of 1934 and business entities that have \$250 million or more in gross assets for book purposes). In Notice 2006-06, the Internal Revenue Service eliminated the category of transactions with a significant book-tax difference from the categories of reportable transactions. I.R.S. Notice 2006-06, 2006-5 I.R.B. 385.

In 2004, Treasury and the Internal Revenue Service released Schedule M-3, Net Income (Loss) Reconciliation For Corporations With Total Assets of \$10 Million or More. In general, for taxable years ending on or after December 31, 2004, any corporation (or U.S. consolidated tax group) required to file Form 1120, U.S. Corporation Income Tax Return, that reports total assets at the end of the corporation's (or U.S. consolidated tax group's) taxable year that equal or exceed \$10 million on Schedule L of Form 1120 is required to complete and file Schedule M-3. See Rev. Proc. 2004-45, 2004-2 C.B. 140.

201. See *supra* note 185.

202. One reason why a corporation's tax department may simply be acting as a "compliance shop" is the shortage of available tax professionals to meet the growing demands on a corporation's tax department. See Jay J. Levine, *Resource Challenges for Tax Departments Could Become Opportunities*, BNA DAILY TAX REPORT, Aug. 24, 2006, at J-1 (stating that there are not enough tax professionals to meet the growing demands on a corporation's tax department and that FAS 109 and information technology knowledge are the two most important areas of "core competency").

## VI. CONCLUSION

Tax law academics have long been interested in tax deferral and the time value of money. Many of the issues raised in this area are some of the most interesting and challenging in the tax laws. But equally as important as the tax issues are the issues raised by the financial accounting rules. In fact, in Corporate America, arguably the results under the financial accounting rules are more important than the tax results with respect to a particular transaction, as evidenced by the actions of Enron Corporation and other publicly traded corporations in recent years.<sup>203</sup>

From a tax law standpoint, tax deferral is viewed as a significant benefit for a corporation. Even if tax rates remain constant over time, there is a time value of money benefit to defer paying taxes. From an accounting standpoint, however, tax deferral is viewed, on many occasions, as a minor benefit. Exclusions (and deductions that are equivalent to exclusions, such as the manufacturing deduction) are seen as a much greater benefit to Corporate America, which highly covets such items. Permanent differences may increase a corporation's net income and therefore its EPS while also reducing a corporation's effective tax rate. In contrast, tax deferral items, referred to as temporary differences for financial accounting purposes, do not immediately increase a corporation's net income or its EPS, and also do not reduce a corporation's effective tax rate. The primary benefit of temporary differences, which may not be applicable in all cases, is to temporarily increase a corporation's cash flow, which, while certainly not unimportant, is not seen as significant a benefit to corporate management as increasing the corporation's net income or EPS.

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203. One of the most famous examples of a publicly held corporation valuing financial accounting results over tax results is Chrysler Corporation, when it changed from the LIFO (last-in, first-out) inventory method to FIFO (first-in, first-out) inventory method in 1970. *See* KIESO, ET AL., *supra* note 12, at 395. As a result of the change, Chrysler owed an additional \$53 million in taxes that it had deferred over 14 years. *Id.* However, Chrysler only reported a \$7.6 million loss on its income statement after the change rather than a \$27 million loss if it had not made the inventory change. *Id.*